S. HRG. 101-625

THE EXPEDITED FUNDS AVAILABILITY ACT OF 1988

HEARING

BEFORE THE

SUBCOMMITTEE ON
CONSUMER AND REGULATORY AFFAIRS

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

TO REVIEW THE EXPEDITED FUNDS AVAILABILITY ACT OF 1988
[PUBLIC LAW 100-86]

MARCH 1, 1990

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THE EXPEDITED FUNDS AVAILABILITY ACT OF 1988

THURSDAY, MARCH 1, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON CONSUMER AND REGULATORY AFFAIRS,
Washington, DC.

The subcommittee met at 1:36 p.m., in room SD-538 of the Dirksen Senate Office Building, Senator Alan J. Dixon presiding.

Present: Senators Dixon and D'Amato.

OPENING STATEMENT OF SENATOR DIXON

Senator DIXON. Ladies and gentlemen, our subject today is the Expedited Funds Availability Act, which was enacted by the Congress as part of the Competitive Equality Banking Act in 1987 and was implemented by regulation CC, which became effective on September 1, 1988.

This hearing is timely for several reasons. While temporary schedules for funds availability have been in effect for more than 1½ years, permanent schedules will go into effect 5 months from today. Within the next few weeks the Federal Reserve will have submitted six of the eight reports mandated by the act.

In addition, funds availability relates to two other issues which the subcommittee will be active with this winter and spring.

The subcommittee has been working on legislation that would require depository institutions to cash Government checks. One might view that legislation as "immediate" funds availability for Government checks, not just "next day" or "expedited" funds availability. Under certain conditions, that may well be appropriate. This hearing may have some useful lessons for us to consider.

Second, I would like to announce that the subcommittee will be exploring the regulatory burden issue this spring. I want to make sure that regulations are achieving their purpose and are implemented by the most practical, efficient means. This hearing covers a small piece of that ground.

I support the Expedited Funds Availability Act. I voted for the Senate bill. Today, we want to find out whether the act is achieving its purpose, whether its implementation has been efficient, and whether unintended consequences have occurred or are lurking on the horizon.

I look forward to the testimony of our witnesses and to specific discussion of whether amendments to the act are presently warranted.

In our first panel, ladies and gentlemen, we have Wayne D. Angell, Governor of the Federal Reserve System.

Governor, we are delighted to have you here today, and thank you for your availability.

STATEMENT OF WAYNE D. ANGELL, GOVERNOR, FEDERAL RESERVE SYSTEM

Governor ANGELL. I am pleased to be before the committee this afternoon to discuss the Expedited Funds Availability Act. I will summarize my written statement and ask that it be made part of the hearing record.

The Expedited Funds Availability Act limits the holds that an institution may place on its customers' deposits, requires disclosure of an institution's funds availability policy, and gives the Federal Reserve Board the authority to make improvements to the check clearing system.

We have now had 18 months of experience with this law and it is time to assess its impact on institutions and their customers. The Board is proposing amendments to the Act that would decrease the cost and risk to institutions without jeopardizing the Act's objectives.

In many respects, the objectives of the Act have been achieved. Customers in all regions of the country are now assured prompt availability of funds deposited in transaction accounts, and they now have access to information regarding their institutions' availability policies.

Improved availability and improved information will enhance economic efficiency if the benefits exceed the cost. To the extent that these costs have been achieved without a corresponding increase in cost to banks in their provision of payment services, achievement of these goals represents a positive step in the development of our payment system.

The cost of achieving these objectives, however, has been high. The act imposed significant costs on all institutions, in order to address the problems of the small proportion of institutions that placed the unduly long holds that were the impetus for this legislation. Most institutions provided prompt availability prior to the implementation of the act.

However, virtually no institution had a policy that was in complete conformance with the act's detailed requirements. Requirements of the act compelled all institutions to analyze the implementing regulations, make policy and operational changes, issue numerous types of disclosures and conduct extensive staff training.

Over the long term, institutions are likely to pass these costs on to their customers. I am particularly concerned with the evidence that the act prompted some institutions to actually lengthen the holds that they place on deposits due to the fear that disclosure of prompt availability policy would increase their risks of fraud loss.

This is an unfortunate result that is clearly contrary to the intent of this law. As you know, delayed availability was the result of institutions' efforts to minimize the risk of making funds available for withdrawal before learning whether the deposited checks were returned unpaid.

In recognition of the potential of the act's requirements to increase this risk, Congress gave the Federal Reserve Board authority to improve the check system. Under the new procedures adopted by the Board to expedite the return of unpaid checks, most local and nonlocal checks that are returned unpaid are delivered to the institution of first deposit by the day funds must be made available for withdrawal under the temporary schedule.

I should note, however, that even under the improved check return rules, few local checks will be delivered to the institution of first deposit by the beginning of the day funds must be made available for withdrawal under the permanent schedule, which takes effect, as you mentioned, in September.

Overall, the Board believes that the act has already increased somewhat the risk exposure to institutions despite efforts to improve the check return process. And the Board believes that this risk will increase further under the permanent schedule.

We do not have industry-wide data on the effect of the act on check losses. Anecdotal evidence suggests that while the act does not encourage widespread check fraud, some banks have experienced increased losses and continued attention needs to be devoted to this issue.

The specificity of the act has limited the ability of the Board to adopt regulations to implement the law's objective in the most efficient, cost-effective manner.

Mr. Chairman, had the act provided greater flexibility to the Board in carrying out the intent of Congress, as was the case with the Senate version of the act, many of the problems that have been identified by the Board could have been resolved by regulation rather than by statutory amendment.

Our experience suggests that if greater flexibility were provided in the act, the law's objectives could have been accomplished at a lower cost.

The Board believes that Congress can reduce the cost of complying with the act's requirements and alleviate some of the risk created by the act without jeopardizing the objectives of this law.

The Board recommends adoption of several amendments that would allow the act's objectives to be achieved in a more effective manner.

For example, we believe modification of the availability requirements for deposits made at nonproprietary ATM's would help ensure the continuation of this service to customers, who could continue to choose between the convenience of nonproprietary ATM's and the marginally prompter availability that may be provided if the deposit were made by other means.

My written statement provides a more detailed description of this and of the other proposed amendments.

Finally, I would like to place the Expedited Funds Availability Act in a larger context. This act encourages banks to know their customers because it forces them to rely on their customers' creditworthiness to ensure that they will be reimbursed for checks that are returned after funds have already been made available for withdrawal.

I believe that banks do have a duty to know their customers and assess their creditworthiness. Therefore, we must be very careful in

considering legislation, such as basic banking legislation, that may detract from banks' ability to meet this responsibility.

I appreciate this opportunity to discuss our experience in implementing the act and to suggest certain amendments to improve this law.

Thank you very much.

[The complete prepared statement of Wayne D. Angell follows:]

For Release on Delivery
1:30 p.m., EST
March 1, 1990

Testimony by

Wayne D. Angell

Member, Board of Governors of the Federal Reserve System

before the

Subcommittee on Consumer and Regulatory Affairs

of the

Committee on Banking, Housing and Urban Affairs

United States Senate

March 1, 1990

Mr. Chairman and members of the Subcommittee on Consumer and Regulatory Affairs, I am pleased to appear today to discuss the Expedited Funds Availability Act. This Act limits the length of a hold an institution may place on its customers' deposits, requires disclosure of an institution's funds availability policy, and gives the Federal Reserve Board the authority to make improvements to the check clearing system. We have now had 18 months of experience with this new law and I agree that it is time to undertake an assessment of its impact on both depository institutions and their customers. I believe it is particularly appropriate to assess what changes to the Act should be adopted to decrease the costs and risks to depository institutions without jeopardizing the Act's objectives.

I would like to begin by discussing the objectives of the Act and whether these objectives have been met. Next, I will describe several amendments to the Act that the Board recommends that Congress adopt. I will conclude by relating some lessons that I believe can be learned from our experience with the Act.

First, I believe it is important to evaluate whether the objectives of the Expedited Funds Availability Act have been successfully achieved. The central objective of the Act is to ensure prompt availability of funds deposited in transaction accounts. The minority of institutions that, prior to the Act, had been placing very long holds on their customer's deposits (sometimes of several weeks or more) must now make funds available to their customers for withdrawal in much shorter time

frames. Thus, the abusive practices of a few institutions that prompted Congress to enact this law have been eliminated. Surveys that have been conducted in the wake of the Act indicate that most institutions -- 75 percent or more -- provide their customers with same-day or next-day availability, and therefore do not impose holds as long as those permitted by the Act, except in unusual circumstances. The remaining institutions place blanket holds on their customers' deposits, because they perceive a higher risk of fraud loss from making funds available for withdrawal before having an opportunity to learn whether deposited checks are being returned. These holds are limited by the availability schedules of the Act. Overall, most institutions did not need to make significant changes to their availability policies to comply with the Act's requirements. Of particular concern to me, however, is the evidence that some institutions actually lengthened the holds they place on deposits in response to the Act. Some bankers have indicated that this phenomenon is due to the fear that disclosure of a prompt availability policy would increase the risk of fraud loss.

The second primary objective of the Act is to inform customers of when funds they deposit in transaction accounts will be available for withdrawal. The Act requires an institution to disclose its specific funds availability policy to new customers when an account is established; institutions provided this disclosure to existing customers when the Act became effective. Notices of an institution's availability policy must also be

posted in its branches, at ATMs, and on deposit slips. If an institution delays availability of a particular deposit beyond the times established in its general policy, it must notify the customer of the imposition of the longer hold. In addition, institutions must provide a copy of their availability policy disclosure to any person upon request. This requirement facilitates comparison shopping for those customers that consider availability an important criterion in selecting an institution in which to establish a transaction account.

Examinations of institutions by the federal bank regulatory agencies have shown a high level of compliance with the Act's availability and disclosure requirements. Of course, requiring institutions to provide disclosures to customers won't ensure that the customers will read them. A recent survey conducted by TransData Corporation for the American Banker revealed that only 53 percent of consumers were aware that their institution had a formal funds availability policy. Nonetheless, customers who are interested have access to information regarding when they may start drawing against their deposited funds. Therefore, disclosure of an institution's funds availability policy is a very important achievement of the Act.

Improved access to customers' funds and improved information as to when funds are available for withdrawal may enhance economic efficiency if the benefits exceed the cost. To the extent that these goals have been achieved without a corresponding increase in risk and cost to banks in their

provision of payment services, they represent a positive step in the development of our payments system. In recognition of the importance of achieving these benefits without increasing risks, the Act's third main objective is to minimize the increase in risk to institutions from making funds available for withdrawal promptly by giving the Board authority to improve the check collection and return system. The Board has used this authority to implement changes to expedite the collection of checks and the return of unpaid checks. These rules appear in Subpart C of the Board's Regulation CC.

Prior to the implementation of Regulation CC, the check return system was a slow, labor-intensive operation that relied on visual inspection of indorsements on the check instead of machine-readable information that allows for high-speed automated processing. In addition, returns were often transported by mail rather than by courier, further slowing their trip to the institution of first deposit. A check was generally returned through each of the institutions that collected the check, even though this may not have been the most efficient path to route the return. Under the old check return procedures, most returned checks would not have been received by the institution of first deposit by the time the Act requires that funds be made available for withdrawal under the temporary schedule. An even higher percentage would not have been returned within the time frames established in the permanent schedule.

Under the rules established in Subpart C of Regulation CC, institutions have a responsibility to return checks expeditiously. The regulation is designed to encourage the return of checks by the most direct route (rather than returning a check through each institution that handled the check for forward collection), to encourage the use of couriers rather than the mail to transport returned checks, and to provide for the automated processing of returned checks. These rules have generally speeded the return of unpaid checks. They also have increased the cost to institutions handling returned checks, particularly during this transition period. This increased cost is offset, at least in part, by the fact that a given returned check is now handled by fewer institutions than was the case prior to the implementation of the new procedures. We believe that as banks become more familiar with the new procedures, and as further efficiencies are introduced, the cost of handling returned checks will decline.

A recent survey of returned checks processed by the Federal Reserve indicates that institutions receive most checks that are returned unpaid by the day they must make funds available for withdrawal under the temporary availability schedule. More than 90 percent of nonlocal returns and nearly two-thirds of local returns surveyed were delivered to the institution of first deposit by the day funds must be made available for withdrawal under the temporary schedule. The situation changes dramatically, however, when the shorter

permanent schedule established by the Act becomes effective in September 1990. While almost three-quarters of nonlocal checks in the survey were returned to the institution of first deposit by the day funds must be made available for withdrawal under the permanent availability schedule, virtually no local checks were returned within this time frame (although it may be possible to return many checks that are exchanged directly through local clearinghouse arrangements within this time). I should note, however, that the Act requires that funds be made available for withdrawal by the start of business on the day specified in the availability schedules, and that few returned checks are delivered to the institution of first deposit by the start of its business day.

We believe that the improvements already made have helped to control the level of check fraud that could have resulted from the temporary availability schedule; however, we cannot be sanguine regarding the potential for fraud that could occur after the permanent schedule becomes effective in September of this year. It is difficult to assess the magnitude of check losses in the industry because these losses are often aggregated with other types of losses and are difficult to isolate. The Board does not have any industry-wide data on how the Act has affected check losses. The anecdotal evidence we have received indicates a very disparate impact from institution to institution. While some institutions have stated that their losses after the implementation of the Act are relatively

unchanged from those experienced before the Act took effect, other institutions have reported very large increases in fraud losses. The results suggest that while the Act has not encouraged widespread check fraud, some banks have been subject to increased losses, and continued attention needs to be devoted to this issue.

Generally, the Act envisions two mechanisms to protect institutions from risk of loss when they must make funds available for withdrawal on a prompt basis. First, the Act permits institutions to extend the hold on deposits in certain specified higher-risk situations. These "safeguard exceptions" include deposits to new accounts, large-dollar deposits, deposits to accounts of repeated overdrafters, and deposits that the institution has reasonable cause to believe are uncollectible. However, the Act does not allow institutions to apply these safeguard exceptions to certain check deposits that must be given next-day availability. This risk exposure is addressed in the Board's recommended amendments to the Act, which I will discuss shortly.

Second, the Act attempts to link the availability schedules (with the exception of the next-day availability requirements) with the time that most returned checks would be received by the institution of first deposit. A depositor attempting to defraud an institution should not be able to rely on the availability schedules to ensure that funds are available for withdrawal before a fraudulent check is returned. As noted

earlier, institutions will not be protected by this second mechanism with respect to most local checks under the permanent schedule.

Overall, the Board believes that the Act already has increased somewhat the risk exposure to institutions, despite efforts to improve the check return process. The Act places upward pressure on institutions' costs, and provides greater incentives for institutions to consider customers' creditworthiness before allowing them to establish transaction accounts. These factors may have curtailed services to customers, and undoubtedly will do so to a greater degree in the future.

The Board believes that Congress can alleviate some of these risks without jeopardizing the objectives of the Act, and hopes you will amend the Act to reduce compliance costs and otherwise further its purposes. In this regard, the Board has recommended several proposed amendments to the Act. These amendments have been described in reports to Congress that have been submitted by the Board pursuant to the Act.

For example, when the Act was adopted, Congress indicated that the requirements related to the availability of funds deposited at nonproprietary ATMs should be reassessed, and directed the Board to study this issue and report to Congress on its findings. During consideration of the Act, banks reported to Congress on the processing limitation associated with accepting deposits at nonproprietary ATMs; specifically, that the

account-holding institution does not have information regarding the composition of the deposit that is necessary to place differential holds. Given this limitation, the Act, in effect, allows the account-holding institution to treat any such deposits as though they were composed of nonlocal checks under the temporary availability schedule. Congress anticipated that technological advances would eliminate the need for special treatment of these deposits, once the permanent schedule became effective. The Board has investigated a number of potential alternatives with ATM networks and participating institutions, and has concluded that there is currently no viable solution to address this processing limitation.

Based on this analysis, the Board recommends that Congress amend the Act to treat nonproprietary ATM deposits under the permanent schedule in the same manner as they are treated under the temporary schedule. This would help ensure that deposit-taking at nonproprietary ATMs is not restricted or discontinued by those institutions that believe they need the flexibility to place longer holds on these deposits to limit their risk exposure. If such an amendment were enacted, consumers would continue to be able to choose between the convenience of making a deposit at a nonproprietary ATM and the marginally prompter availability that may be provided if the deposit were made by other means.

In addition to this amendment, the Board recommends the Act also be amended in several other respects. Specifically, the Board recommends amendments that would:

- expand the scope of the safeguard exceptions to include deposits of checks subject to next-day availability;
- provide the Board with greater flexibility to tailor the requirements of the exception hold notices to the exception invoked;
- apply the same condition to next-day availability of Treasury checks and "on-us" checks as is currently applied to other deposits (including deposits of cash, state and local government checks, and official checks) that generally must receive next-day availability;
- resolve the long-run operational and disclosure difficulties associated with the determination of whether payable through checks are local or nonlocal checks;
- clarify the Board's ability to allocate liability among depository institutions as well as among other participants in the payments system, and clarify the damages for which payments system participants may be liable; and
- provide for direct review in the U.S. Court of Appeals of any Board regulation or any other Board order issued pursuant to this Act.

The appendix to this testimony includes the specific amendments proposed by the Board and the rationale for their adoption.

In conclusion, I believe we have learned several lessons from our experience in implementing the Expedited Funds Availability Act. The first lesson is that, in legislation as well as regulation, there are costs and benefits that must be balanced, but which are often unrecognized at the time the laws or rules are adopted. In this instance, the Act has imposed and will impose significant costs on all institutions, including those institutions that were already in substantial compliance with the law's requirements. Most depository institutions provided prompt availability prior to the implementation of the Act; only a small portion of institutions imposed the unduly long holds on their customers' deposits that were the impetus of the legislation. Virtually no institution, however, had a policy that was in complete conformance with the detailed requirements that were subsequently included in the Act. Compliance with the Act required all institutions to analyze the implementing regulations, make certain policy and operational changes, issue numerous types of disclosures, and conduct extensive staff training. Surveys have indicated that the cost of this compliance was not inconsequential. Over the long term, institutions are likely to pass these costs on to their customers, and may become more selective in determining the customers they will serve.

The second lesson learned is that the specificity of the Act has limited the ability of the Board to adopt regulations that carry out the intent of the law in the most efficient, cost

effective manner. Had the Act provided greater flexibility to the Board in carrying out the law's objectives (as was the case with the Senate version of the Act), many of the problems identified by the Board could have been resolved by regulation rather than statutory amendment. While we believe that the Act's objectives, for the most part, have been achieved, these lessons suggest that they might have been accomplished at a lower cost. Finally, our experience with implementing the Act indicates that the short lead time between enactment and the effective date of the law further increased the industry's and the Federal Reserve System's implementation costs, particularly given the complexity of the Act's requirements. As is often the case, if you need something fast, you usually pay more for it.

I appreciate this opportunity to discuss our experience implementing the Expedited Funds Availability Act, and to suggest certain modifications that should be made to the Act. I would be glad to answer any questions that you may have.

Thank you very much.

Attachment

APPENDIX

PROPOSED AMENDMENTS TO THE EXPEDITED FUNDS AVAILABILITY ACT

SECTION 603(e)(2). DEPOSITS AT AN ATM. -- Section 603(e)(2) of the Expedited Funds Availability Act (12 U.S.C. § 4002(e)(2)) is amended as follows:

(1) Revise paragraph (A) to read as follows:

"(A) Not more than 4 business days shall intervene between the business day a deposit described in paragraph (1)(B) is made at a nonproprietary automated teller machine (for deposit in an account at a depository institution) and the business day on which funds from such deposit are available for withdrawal."

(2) Delete paragraphs (B) and (C); and

(3) Redesignate paragraph (D) as paragraph (B).

COMMENT

The proposed amendments would provide that, under the permanent schedule, all deposits to nonproprietary ATMs would continue to be treated in the same manner as deposits of nonlocal checks, i.e., they must be made available for withdrawal on the fifth business day after the business day of deposit. Under the temporary schedule, both deposits to nonproprietary ATMs and deposits of nonlocal checks must be made available on the seventh business day after the business day of deposit. Currently, the Act provides that, under the permanent schedule, deposits to nonproprietary ATMs generally be treated identically to deposits at proprietary ATMs (cash, next-day, and local checks available

on the second business day after deposit, nonlocal checks available on the fifth day after deposit).

The Act equalized the proprietary and nonproprietary ATM rules under the permanent schedule in anticipation that ATM technology would advance sufficiently by September 1, 1990, so that depository institutions could capture and verify deposit information from the two types of ATMs in the same amount of time. However, the Board believes that depository institutions and ATM network operators have indicated that the industry has not yet identified a viable solution to nonproprietary ATM processing limitations.

Although the capability does exist to provide information regarding the composition of deposits made at nonproprietary ATMs, all identified solutions are costly and would likely result in increased fees for customers who make deposits at nonproprietary ATMs. In addition, depository institutions and ATM operators have expressed concern that the potential for fraud will increase if institutions must give second-day availability to deposits made at nonproprietary ATMs. Substantial increases in operating costs or fraud losses could lead some institutions to cease accepting deposits at nonproprietary ATMs, resulting in a degradation of shared ATM network efficiency and slower collection of checks, which would be contrary to the intent of the Act.

Although § 604(e) of the Act provides that the Board may suspend the availability requirements for any classification of checks if depository institutions are experiencing an

unacceptable level of check-related fraud losses, the Board must provide evidence to Congress to substantiate such an action. Because no such evidence will exist until after the permanent schedule goes into effect, some depository institutions could suffer significant fraud losses before the Board could suspend the availability schedules for deposits to nonproprietary ATMs; other institutions may discontinue offering this service in anticipation of such fraud losses.

The proposed amendment would help ensure that deposit-taking at nonproprietary ATMs is not restricted or discontinued by those institutions that believe they need the flexibility to place longer holds on these deposits to limit their risk exposure. In addition, customers would continue to be able to choose between the convenience of making a deposit at a nonproprietary ATM and the marginally prompter availability that may be provided if the deposit were made by other means.

SECTION 604 SAFEGUARD EXCEPTIONS. -- Section 604 of the Expedited Funds Availability Act (12 U.S.C. § 4003) is amended as follows:

(1) In subsection (b), insert "(a)(2)," after "subsection";

(2) In subsection (c), delete "(F)" after "subsections (a)(2)";

(3) In subsection (d), insert "(a)(2)," after "subsections"; and

(4) In subsection (f)(2)(C) insert "(b)," after "subsection".

COMMENT

(1), (2), and (3) Exceptions for Next-Day Checks

The proposed amendments would expand the scope of most of the § 604 exception holds to include deposits of all "next-day" checks, such as U.S. Treasury checks, state and local government checks, and depository checks. Currently, the exceptions for large or redeposited checks or accounts with repeated overdrafts in § 604(b), the reasonable cause exception in § 604(c), and the emergency conditions exception in § 604(d) do not apply to some or all of the next-day checks covered in § 603(a)(2).

A large number of depository institutions have expressed concern that the inapplicability of these exceptions causes excessive exposure to risk from the return of checks that must be accorded next-day availability. In particular, depository institutions have noted the ease of forgery of these checks. The Board is aware of a number of cases of this type of

check fraud and believes that fraud will increase as forgers become more familiar with the Act, Regulation CC, and check collection practices. Fraud loss reduction would benefit depository institutions as well as their customers, who otherwise would likely face increased service fees.

(4) Notice of Large-Dollar, Redeposited Check, and Repeated Overdraft Exceptions

The proposed amendment would grant the Board more flexibility in tailoring the requirements for exception hold notices to the exception invoked. Under § 604(f), whenever any exception to the schedules is invoked, the depository institution must notify the customer of the exception hold. Although individual notices may be appropriate in the case of the reasonable cause exception, which is invoked on a case-by-case basis, they may not be appropriate for the large-dollar, redeposited check, or repeated overdraft exceptions. These exceptions may be invoked for all deposits over a specified amount (in the case of the large-dollar exception), all checks covered by the redeposited check exception, or all deposits during some time period (in the case of the repeated overdraft exception). In these cases, it would be more efficient and less costly to depository institutions if the notice requirement could be tailored to the exception invoked. For example, a single notice to repeated overdrafters describing the special schedules applicable to the account for the time the exception is in effect may be appropriate. Customers would also benefit from receiving advance notice of any exception holds that will be in effect

under certain conditions or for a certain period of time, rather than receiving on-the-spot or after-the-fact notices upon each deposit.

SECTION 603(a)(2). NEXT BUSINESS DAY AVAILABILITY FOR CERTAIN DEPOSITS. -- Section 603(a)(2) of the Expedited Funds Availability Act (12 U.S.C. § 4002(a)(2)) is amended as follows:

(1) In paragraph (A) --

(A) delete the word "and" at the end of clause (i);

(B) insert the word "and" at the end of clause (ii); and

(C) add a new clause (iii) as follows:

"(iii) is deposited in a receiving depository institution staffed by individuals employed by such institution."

(2) Revise paragraph (E) to read as follows:

"(E) A check which --

(i) is deposited in a branch of a depository institution staffed by individuals employed by such institution; and

(ii) is drawn on the same or another branch of the same depository institution if both branches are located in the same State or the same check processing region."

COMMENT

The proposed amendment would make the rules governing availability of Treasury checks and checks drawn on the receiving depository institution ("on us" checks) consistent with the rules for deposits of cash and other checks that receive next-day availability. The Act requires deposits of cash and certain

government and depository (cashier's, certified, teller's and certain other) checks to be made available for withdrawal on the next business day after the business day of deposit. One of the conditions of next-day availability for these deposits is that the deposit be made at a staffed teller facility. This condition recognizes the difficulties in ascertaining the contents of deposits at ATMs and other unstaffed facilities in time to update a depository institution's books so that it can make funds available at the opening of the next business day.

The current provisions of the Act provide that U.S. Treasury check deposits must be given next-day availability even if the checks are deposited at a proprietary ATM, and "on us" checks must be given next-day availability if deposited at a "branch," which may include an ATM located at a branch. Cash deposits under similar circumstances need not receive next-day availability.

As a practical matter, depository institutions and ATM networks have stated that they are unable to verify the contents of deposits made at ATMs in time to provide next-day availability for these checks. This problem exists for Treasury and "on us" checks to the same extent as it exists for cash and other types of checks that the Act recognizes need to be deposited at a staffed teller facility to receive next-day availability. Thus, the Board proposes that the Act be amended to apply the staffed teller facility condition for next-day availability of Treasury and "on us" checks.

SECTION 602(17). DEFINITION OF "ORIGINATING DEPOSITORY INSTITUTION". -- Section 602(17) of the Expedited Funds Availability Act (12 U.S.C. § 4001(17)) is amended to read as follows:

> "(17) The term 'originating depository institution' means the branch of a depository institution on which a check is drawn or through or at which a check is payable, as prescribed by regulations of the Board."

COMMENT

This amendment would resolve the long-run operational and disclosure difficulties associated with payable through checks by explicitly defining "originating depository institution" to include payable through and payable at banks. Regulation CC, as originally adopted, interpreted the definition to include payable through banks and provided that a payable through check is considered local or nonlocal based on the location of the payable through bank (where the check is actually sent for collection).

In a July 1988 ruling in a suit brought against the Board by the Credit Union National Association ("CUNA"), the U.S. District Court for the District of Columbia ruled that the determination of whether a credit union payable through draft is local or nonlocal should be based on the location of the credit

union[1/] rather than the location of the payable through bank. The Board modified Regulation CC to conform to the court ruling and to address the disclosure of availability policies with respect to payable through checks. Because the routing number on the payable through check is that of the payable through bank and not that of the credit union, customers and depository institutions cannot rely on the routing number to determine whether the check is local or nonlocal. Depository institutions that distinguish between local and nonlocal checks when placing holds must either describe to their customers in a disclosure statement how to determine whether a payable through check is local or nonlocal, or inform their customers that they may inquire regarding the availability of particular payable through checks.

The District Court's ruling has created significant operational difficulties for depository institutions trying to comply with the availability schedules of the Act, because reliance on the routing number is the only automated mechanism that can be used to determine whether a check is local or nonlocal. Consequently, if depository institutions wish to distinguish between local and nonlocal checks when placing holds, they must handle payable through checks manually, which is a costly, time-consuming process.

[1/]Although most payable through checks are written on credit unions, they may also be written on other types of depository institutions. For purposes of this comment, we will use the term "credit union" to represent the depository institution on which the payable through check is written.

Although this problem has been alleviated by labeling requirements for payable through checks that help consumers and depository institutions to readily identify payable through checks and to determine whether the check is local or nonlocal based on the first four digits of the routing number of the credit union, these requirements do not solve the operational difficulties faced by certain depository institutions that still must examine these checks manually to make the local-nonlocal determination. The proposed amendment to the Act would eliminate these problems and would be consistent with the scheme of the Act to allow longer holds on checks that must be sent to nonlocal banks for collection.

SECTION 611(f). AUTHORITY TO ESTABLISH RULES REGARDING LOSSES AND LIABILITY AMONG DEPOSITORY INSTITUTIONS. -- Section 611(f) of the Expedited Funds Availability Act (12 U.S.C. § 4010(f)) is revised to read as follows[2/]:

"(f) Authority to establish rules regarding losses and liability among depository institutions. The Board is authorized to impose on or allocate among depository institutions or other entities participating in the payments system, including States and political subdivisions thereof on which checks are drawn, the risks of loss and liability in connection with any aspect of the payment system, including the receipt, payment, collection, or clearing of checks, and any related function of the payment system with respect to checks. Liability under this subsection shall not exceed the amount of the check giving rise to the loss or liability, including finance charges, reasonable attorney's fees, and other expenses related to the check, and, where there is bad faith, other damages, if any, suffered as a proximate consequence of any act or omission giving rise to the loss or liability."

COMMENT

This amendment clarifies the Board's ability to allocate liability among depository institutions as well as among other participants in the payments system, such as states and their political subdivisions. Other entities besides depository institutions are involved in the collection and payment of

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[2/]Added language is double-underlined.

checks. Some states and political subdivisions issue warrants drawn directly on themselves. These warrants are often used to pay employees, vendors, pensioners, and those receiving public assistance; they are thus very important to the recipients. In addition, other nonbank payors, such as insurance companies, draw checks directly on themselves that are also important to the recipients.

Under the 11th Amendment to the Constitution, suits against state governments are barred in federal court unless Congress subjects the states to federal jurisdiction in unequivocal statutory language. (See Atascadero State Hospital v. Scanlon, 473 U.S. 234 (1985).) Section 611(f) does not clearly authorize the Board to allocate liability for losses, such as those resulting from the mishandling of a returned check, among entities such as states or their political subdivisions or other nonbank payors. The proposed amendment would eliminate this ambiguity by allowing the Board to impose on or allocate among such entities the risks of loss and liability in connection with any aspect of the payments system, including the payment of checks. Liability under these provisions could then be enforced in the appropriate courts.

The amount of liability in cases against states or their subdivisions or other nonbank payors would be limited to the damages provided for in this subsection. The amendment would not allow against states or their subdivisions or other nonbank payors the punitive damages or the special class action awards

that may be had against depository insitutions under § 611(a) and (b).

The amendment also clarifies that a depository institution or other payments system participant may be liable for expenses related to the check such as finance charges and reasonable attorney's fees. The measures of damages for violations of Subpart C of Regulation CC are derived from the Uniform Commercial Code ("UCC"). Interpretations vary among state courts as to if and when the UCC damage provisions include attorney's fees. This amendment would provide for uniformity in the measure of damages for violations of Board rules governing the payments system.

SECTION 609 REGULATIONS AND REPORTS BY THE BOARD. -- Section 609 of the Expedited Funds Availability Act (12 U.S.C. § 4008) is amended by adding a new subsection (g) as follows:

"(g) JUDICIAL REVIEW. -- Any party aggrieved by any regulation prescribed by the Board pursuant to this Act, or any other order of the Board under this Act, may obtain a review of such regulation or order in the United States Court of Appeals within any circuit wherein such party has its principal place of business, or in the Court of Appeals in the District of Columbia, by filing in the court, within thirty days after the entry of the Board's order or final rule, a petition praying that the regulation or order of the Board be set aside. A copy of such petition shall be forthwith transmitted to the Board by the clerk of the court, and thereupon the Board shall file in the court the record made before the Board, as provided in section 2112 of title 28, United States Code. Upon the filing of such petition, the court shall have jurisdiction to affirm or set aside the regulation or order of the Board and to require the Board to take such action with regard to the matter under review as the court deems proper. The findings of the Board as to the facts, if supported by substantial evidence, shall be conclusive."

COMMENT

The proposal amends § 609 by adding a new subsection (g) providing for direct review of any regulations adopted by the Board and any other Board orders in the courts of appeal. This follows the approach adopted in § 9 of the Bank Holding Company Act (12 U.S.C. § 1848).

A factual hearing in a district court is not necessary if judicial review is based upon the administrative record. If the administrative record forms the basis for review, requiring aggrieved persons to go first to the district court results in unnecessary delay and expense and undesirable bifurcation of the reviewing function between the district courts and the courts of appeal.

Furthermore, the operation of the payments system, including the collection and return of checks, is an intricate subject with which few courts are familiar; any court must therefore of necessity rely heavily on the expertise of the Board. If a reviewing court was not in possession of sufficient facts to conduct adequate review, it would have to remand the case to the Board for further factual development. Under these circumstances, there is no reason to have yet another level of review in the process, and no need for district courts to conduct a de novo review of facts already established by the Board.

Senator DIXON. Thank you, Governor Angell.

We have here the distinguished Senator from New York State. Do you have any statement at this time?

Senator D'AMATO. Mr. Chairman, let me first commend you and congratulate you for conducting this hearing.

As you know, many members have at times raised these issues, but you have taken the time to hold these hearings and attempt to do something.

I note with great interest that some of those members aren't here who would give rise to that, and that is kind of an inside story here. But, certainly, there is probably no area that creates greater concern to the average person than the issue of funds availability.

And let me say to you, Mr. Chairman, because you have taken the time and I think you have exhibited the kind of balance that is so necessary, recognizing legitimate needs and also recognizing that someone pays for various services, and that it is not free.

And so I am saying to you now that I look forward to your leadership and will work with you because you have demonstrated the time and commitment and energy that this area has not heretofore had in a chairman.

And I would ask that the balance of my statement be included in the record, as if read in its entirety, Mr. Chairman.

OPENING STATEMENT OF SENATOR D'AMATO

Mr. Chairman, let me congratulate you for conducting this hearing. Few things in the banking business are of more direct concern to the average person than funds availability. The Expedited Funds Availability Act was intended to address this important matter.

It appears that overall, this legislation has been of genuine consumer benefit but it is also possible that the funds availability changes have had some unintended consequences. This hearing is an important opportunity to examine some of these unintended consequences.

I am aware that considerable controversy surrounds the Fed's proposed amendments. Such matters are contentious and that reasonable persons often differ as to both the interests of consumers and the effect that various legislative proposals can have on consumers. I want to assure you, Mr. Chairman, that I stand ready to cooperate with you in producing workable legislation on the whole range of consumer banking issues that you have attempted to address.

Senator DIXON. I thank my distinguished friend from New York State.

Governor Angell, I note that we have a rollcall vote. The Senator from New York and I will be obligated to leave shortly. Rather than having you wait for our return, I'm going to ask a couple of quick questions. If my friend from New York State has questions to ask, he is welcome to. And then I think I will give you the rest of my questions in writing so that you don't have to wait here for 15 minutes or so.

I regretfully advise panel two that I will get back as quickly as I can. But, as you can see, we do have a rollcall.

Governor, the consumer groups claim that banks shortened their hold policy as a result of the passage of this act. There seems to be some dispute about those numbers, but is that accurate, that a large percentage of banks have shortened their hold policies?

Governor ANGELL. That is not accurate, Mr. Chairman. There have been more banks that have lengthened their schedules than there have been banks that have reduced their schedules because in so many regions of the country, we had immediate availability.

And we have actually worsened that availability because of the increased risk provided.

Senator DIXON. I'm going to give you a series of written questions here, and that will be one of them.

To the extent that you can break that down to any degree of certainty, I think that it would help us a good deal.

You did touch briefly on the nonproprietary ATM's and your ideas about modification of that rule. Can you quickly just touch on that for me?

Governor ANGELL. Yes, Mr. Chairman. We were hoping, and the Congress was hoping at the time, that we would have some technological breakthrough that would enable us to do a better job at an ATM that is off the bank's premises, at a convenience or a grocery store, that we would be able to separate out the local and the non-local checks.

So that we could, on the permanent schedule, make local checks available on the next day. That technological breakthrough has not occurred. And, consequently, a solution would be so expensive that we believe that consumers will be harmed by a withdrawal of banks from nonproprietary ATM's, lessening the availability of this service. We believe it would be better to preserve this service by letting the local and the non-local checks have the same availability.

So, for the banks that have a fast availability and customers that have that fast availability, they will not in a sense fall into that kind of a penalty.

So we believe it is too costly because we have not had the technological means, and industry has not, to make that step.

So we are asking your serious consideration to permitting all of those checks to be batched in the same availability process.

Senator DIXON. I thank you, and our staff will be working with you and others in connection with those suggested modifications.

I appreciate your testimony, Governor. I regret very much that I have to cut off my questioning. I have some other questions. If you would be so kind at your earliest opportunity to respond in writing to my written questions—we have a variety of them—I think it will help us in evaluating what we view as some modifications that may be justified.

And I will appreciate hearing from you at your earliest opportunity so that we can consider that in short order.

Governor ANGELL. Mr. Chairman, we will provide you a timely response to your questions. And I would assure you that the staff of the Federal Reserve deems it very, very important that we have the kind of working relationship with your staff. And we will provide as much information as we can to enable you to make the decision needed in the interests of the check system of this country.

Senator DIXON. Thank you, Governor Angell.

Ladies and gentlemen, in panel two, we will have David T. Wittman, vice president/manager, Chase Manhattan Bank; Stephen S. Cole, president, Cash Station, Inc., in Chicago; Margaret Rectanus, vice president/assistant general manager, Credit Union Products and Services of Madison, WI; Michelle Meier, counsel for government affairs, Consumers Union of the United States; and Ed Mierzwinski, consumer lobbyist, U.S. Public Interest Research Group.

I thank you, Governor Angell, and if the others of you would step up, I do need to go vote and we will be temporarily in recess.

Thank you.

[Recess.]

Senator DIXON. This hearing will come to order.

I apologize to all of you and I know that you are understanding enough to know that we have to go vote when the bell rings. I appreciate your courtesy in waiting.

As I said previously, this second panel will consist of Mr. David Wittman, vice president and manager at Chase Manhattan; Stephen S. Cole, president, Cash Station in Chicago; Margaret Rectanus, vice president, assistant general manager of Credit Union Products and Services in Madison, WI. And, Michelle Meier, counsel for government affairs in the Consumer Union of the United States; and Mr. Ed Mierzwinski, consumer lobbyist, U.S. Public Interest Research Group.

We are delighted to have you all and I take it we will go in the order in which you are sitting, from left to right.

Mr. Wittman.

STATEMENT OF DAVID T. WITTMAN, VICE PRESIDENT AND MANAGER, REGULATORY COMPLIANCE GROUP, CHASE MANHATTAN BANK, REPRESENTING BOTH THE AMERICAN BANKERS ASSOCIATION AND THE CONSUMER BANKERS ASSOCIATION

Mr. WITTMAN. Good afternoon, Mr. Chairman. I am vice president and manager of the Regulatory Compliance Group of Chase Manhattan Bank in New York. I am currently a member of the Consumer Bankers Association's Community Banking Task Force, and I was chairman of the American Bankers Association Compliance Executive Committee in 1989.

I am pleased to appear before you this afternoon on behalf of the ABA and CBA on the subject of Expedited Funds Availability Act.

The Act was passed on August 10, 1987. Its purpose is to make funds for deposited checks available to customers within specified schedules, and to improve the check processing system. Regulation CC implements the act and became effective September 1, 1988.

The terms of the act were unusually rigid and detailed in their specificity. Consequently, regulation CC is lengthy and complex.

Compliance with the regulation has been further complicated by the need to reconcile State and Federal laws, and by revisions to the regulations as a result of litigation subsequent to its adoption.

These factors coupled with the relatively short implementation period created a substantial and costly compliance burden for depository institutions. The transition has been relatively smooth,

however, in large part due to the extensive efforts of the banking industry and the Federal Reserve Board.

Even depository institutions already providing availability of funds equal to or better than those mandated by the act were not exempt from the compliance burden of regulation CC.

And there were thousands of such banks, particularly in rural areas as well as all of those depository institutions located in States which had previously passed their own funds availability law, such as New York and California; simply satisfying the general availability schedules was not sufficient to avoid a major compliance effort.

First, it is doubtful that any depository institution's policy mirrored the regulation exactly. Thus, some adjustment to current policy was necessary in order to comply with the new regulation. Second, in addition to the mandated funds availability schedules, the act required new disclosures and specific employee training programs.

In addition to compliance, the industry's other major concern with the act continues to be fraud. While only preliminary data on fraud losses are available at this time, losses on uncollectible checks appear to have risen since implementation of regulation CC and other funds availability laws.

Moreover, the potential for fraud would dramatically increase when the funds availability schedules are shortened this September. This may be exacerbated if basic banking is passed. Under the shortened availability schedules, it is likely that banking institutions will often be unable to learn that a check, especially a local check, is not payable before they must make funds available. Such a system is easily exploited, particularly if individuals can demand to open accounts at several different depository institutions under a basic banking statute.

Accordingly, we ask you to consider several amendments to reduce the risks of fraud losses. Other suggested amendments accommodate the operational limitations of check process, or are technical in nature.

The first amendment limits next day availability on certain checks to the first $5,000 and applies other exceptions to the next day availability schedule.

The amendment, for example, allows depository institutions the discretion to release only the first $5,000 of a Government check or cashier's check on the day following deposit.

The second amendment modifies the permanent availability schedule for deposits into shared automated teller machines.

Under the permanent availability schedule of the act, because of operational limitations, all such deposits, in effect, must be available on the second day following deposit.

The shortened availability schedule significantly increases the risk that funds will be released before the customer's institution can learn that the check is uncollectible.

In many cases, the only practical and prudent alternative for depository institutions is to discontinue accepting deposits into shared ATM's, eliminating a valuable customer service.

Depository institutions in States where branching is restricted, such as Illinois, rely heavily on shared ATM's to serve their customers and would be particularly affected absent an amendment.

The third amendment eases some of the compliance burdens that permit depository institutions to provide onetime notices when funds will be held beyond the statutory schedules.

The onetime notice of exception to the schedule would apply, for instance, in cases when the reason for the exception is that an account was repeatedly overdrawn.

The fourth amendment extends the period during which an account is considered new, from 30 days to 6 months.

The definition of "new account" is significant because banks generally may exempt deposits made into new accounts from the funds availability schedules.

New accounts are more susceptible to losses because perpetrators of fraudulent check schemes rely both on multiple accounts by persons not long or well-known to the bank and also on the ability to withdraw funds before the bank knows the checks are uncollectible.

A fifth amendment requires depository institutions to address the operational difficulties regarding the treatment of credit union share drafts payable through a bank.

The two remaining amendments are relatively minor. One explicitly subjects State and local governments on which checks are drawn to the liability rules.

The other amends the act so that the U.S. Treasury checks deposited into ATM's are treated in the same manner for purposes of funds availability schedules, as are other next day availability items.

Mr. Chairman, we appreciate the opportunity to testify and would be happy to answer any questions.

[The complete prepared statement of David T. Wittman follows:]

STATEMENT OF
DAVID T. WITTMAN
VICE PRESIDENT, MANAGER OF THE REGULATORY COMPLIANCE GROUP
THE CHASE MANHATTAN BANK, N.A.

ON BEHALF OF
THE AMERICAN BANKERS ASSOCIATION AND
THE CONSUMER BANKERS ASSOCIATION

BEFORE
THE SENATE SUBCOMMITTEE ON
CONSUMER AND REGULATORY AFFAIRS

CONCERNING
THE EXPEDITED FUNDS AVAILABILITY ACT

March 1, 1990

Mr. Chairman and members of the Subcommittee, my name is David T. Wittman and I am Vice President, Manager of the Regulatory Compliance Group of The Chase Manhattan Bank, N.A. in New York, New York. I am currently a member of the Consumer Bankers Association's ("CBA") Community Banking Task Force and I was Chairman of the American Bankers Association's ("ABA") Compliance Executive Committee in 1989. I am pleased to appear before you this afternoon on behalf of the American Bankers Association and the Consumer Bankers Association on the subject of the Expedited Funds Availability Act.

ABA is the national trade association representing commercial banks of all sizes, types, and locations. The combined assets of ABA's members represent approximately 95 percent of the industry total.

CBA was founded in 1919 to provide a progressive voice for the retail banking industry. CBA represents approximately 950 federally insured banks and thrift institutions that hold more than 80 percent of all consumer deposits, and more than 70 percent of all consumer credit held by federally insured depository institutions.

The Expedited Funds Availability Act ("the Act") was enacted on August 10, 1987. Its purpose is to make funds from deposited checks available to customers within specified schedules and to improve the check processing system. Regulation CC implements the Act and became effective September 1, 1988.

The terms of the Act were unusually rigid and detailed in their specificity. Consequently, Regulation CC is lengthy and complex. Compliance with the regulation has been further

complicated by the need to reconcile state and federal laws and by revisions to the regulation as a result of litigation subsequent to its adoption. These factors, coupled with the relatively short implementation period, created a substantial and costly compliance burden for depository institutions. The transition has been relatively smooth, however, in large part due to the extensive efforts of the banking industry and the Federal Reserve Board.

In spite of the cost of the Act to the banking industry, it appears that the statute has had little positive effect on consumers: most banks were already releasing funds within the statutory funds availability schedules before passage of the Act.

In addition to compliance, the industry's other major concern with the Act continues to be fraud. While only preliminary data on fraud losses are available at this time, losses on uncollectible checks appear to have risen since implementation of Regulation CC and other funds availability laws. Moreover, the potential for fraud will dramatically increase when the funds availability schedules are shortened this September. This would be exacerbated if basic banking legislation is passed. Under "The Basic Banking Services Access Act of 1989" (S. 907), introduced by Senator Metzenbaum, financial institutions must offer an account to anyone who applies for one. They may reject an application only if they find a "material misrepresentation" in an application. Under the shortened availability schedules, it is very likely that banking institutions will often be unable to learn that a check, especially a local check, is not payable before they must make funds available. Such a system is easily exploited particularly if individuals can demand to open accounts at several different depository institutions under a basic banking statute.

Accordingly, we ask you to consider several amendments to reduce the risks of fraud losses. Other suggested amendments accommodate the operational limitations of check processing or are technical in nature. These amendments will not change the substance of the Act. It should not come as a surprise that the implementation process of such a complex law has brought out some specific provisions which need modification. Most amendments have been endorsed by the Federal Reserve Board. One such amendment, which subjects "next-day availability" items to the exceptions to the schedule, was included in S. 1886 passed by the Senate in March 1988.

Length and Complexity of the Act

The Expedited Funds Availability Act limits the time depository institutions may "hold" funds from checks deposited into a customer's account. The Act requires depository institutions to release funds from deposits within specified funds availability schedules. In addition, the Act contains provisions regarding disclosure of funds availability policies and interest accrual.

In brief, the Act:

- limits the time banks may delay availability of funds as prescribed by the schedules;
- restricts exceptions to the schedules to certain circumstances;
- requires banks to provide notices to customers when funds are held beyond the schedules;
- mandates that banks begin to accrue interest on deposits into interest bearing accounts no later than the time the bank receives provisional credit;
- requires disclosure of the funds availability policy to potential and existing customers, and requires notices to be provided on all preprinted deposit slips, posted at branch locations, and provided at ATMs; and
- requires banks to establish procedures to ensure compliance with, and to educate employees about, the requirements of the regulation.

While the concept of the Act may have appeared straightforward and simple, translating it into a workable regulation proved otherwise. The final regulation filled 124 small print pages of the Federal Register!

Moreover, the Act is replete with exceptions to exceptions to exceptions, making compliance exceedingly difficult. For example, under the statute banks generally must release funds by a certain time according to a statutory schedule. However, funds may be held longer for specified reasons -- except for items generally subject to next-day availability -- except that some, but not all, next-day availability items (such as cashiers' and certified checks) may be held beyond the schedule, but only under one of the specific exceptions.

Reconciling state funds availability laws with the Act further complicated implementation efforts. While the Act attempts to preempt state funds availability law it is not a simple process. For example, if the state law provides earlier access to funds, then the state law supersedes federal law, but only in regard to the funds availability schedules.

The problem with this dual law approach is that the definitions and tiers of schedules of state laws vary from those of the federal law. For example, a state law might distinguish among three types of checks for purposes of the funds availability schedules. It might apply different schedules to local checks; in-state, nonlocal checks; and out-of-state, nonlocal checks. In contrast, the federal law only recognizes local and nonlocal schedules. The state law schedules, exceptions, or distinctions among types of checks do not necessarily correspond with those of the federal law.

Consequently, in some cases, federal schedules applied to certain checks and state schedules applied to others.

Costs and Regulatory Burden of The Act

The complexity and length of the regulation compounded the costs of implementing the Act. Examples of costs associated with implementation include:

- interpretation of the regulation;
- review and revision of existing funds availability policies and procedures;
- reviewing and planning of implementation by senior bank personnel;
- staff training, including seminars, training videos, and manuals;
- drafting, printing, and mailing disclosure statements to customers;
- purchase of new check processing equipment;
- software costs to incorporate the new schedules; and
- monitoring compliance.

Translating the cost of implementation of Regulation CC into exact dollar amounts is difficult for many banks. "Soft" costs associated with management time are difficult to quantify because many institutions do not keep detailed time allocation records. Thus, most depository institutions are unable to isolate costs solely attributable to Regulation CC.

While cost data for the industry in general are not available, some individual banks have provided estimates of the costs of implementation. One bank with $10 billion in assets and 65 offices estimated its cost of implementation at $900,000. Of that sum, $250,000 represented dollars spent for purchase of equipment, notices, and materials; $650,000 represented personnel expenses for employees who were diverted from programming, operations, and branch management activities to develop and implement the necessary changes. A second bank with $70 billion in assets and 450 offices recorded expenses of $1 million dollars, half of which represented "hard" dollars. "Hard" costs include expenditures for items such as equipment, software, and disclosure statements. Another bank with $7 billion in assets estimated that its upfront costs were $65,000, but this figure excludes the human resources needed for bringing the bank into compliance.

Even depository institutions already providing funds availability schedules equal to or better than those mandated by

the Act were not exempt from the compliance burden of Regulation CC. And there were thousands of such banks -- particularly in rural areas, as well as all of those depository institutions located in states which had passed their own funds availability law such as New York and California. Simply satisfying the general availability schedules was not sufficient to avoid a major compliance effort. First, it is doubtful that any depository institution's policy mirrored the regulation exactly. Thus, some adjustment to current policy was necessary in order to comply with the new regulation. For instance, a banking institution may have defined the terms "new account" or "large dollar check" differently from the regulation or may have applied a slightly different schedule to a particular class of check. Second, in addition to the mandated funds availability schedules, the Act required new disclosures and specific employee training programs. According to the Federal Reserve Board's June 1989 "Report to Congress Under the Expedited Funds Availability Act," these costs -- employee training and printing and mailing of disclosure statements to the customer -- were the most costly aspects of Regulation CC implementation.

In spite of the complexity and length of the new regulation and the short implementation period, the transition to the new rules was relatively manageable, in large part due to the efforts of the industry and the Federal Reserve Board. The banking industry endeavored to educate depository institutions about Regulation CC quickly and to assist in implementation. ABA hosted a symposium to assist bankers in reviewing and composing comments on the proposed regulation. After adoption of the final regulation, ABA, CBA, and many other organizations conducted educational seminars across the country, arranged national compliance teleconferences, developed training videos and compliance manuals, and provided answers to telephone inquiries.

The Federal Reserve Board worked assiduously to draft the proposal, review over 1,000 comments, and complete final regulations in minimal time. The Board has received more comments for proposals under the Act than for any other regulation. These efforts allowed depository institutions as much time as was feasible under the time constraints of the Act to comply with the new regulation. In addition, the Board conducted nationwide educational seminars, both during the comment period and after adoption of the final regulations, and offered a "hotline" program to answer inquiries on Regulation CC. The Board reported that in 1988 it spent over $2.1 million to provide educational assistance in implementing the Act and Regulation CC.

The Board has been working with the industry since before the passage of the Act to improve funds availability and the return item process through open discussion meetings and briefings. We believe that, as a result, Regulation CC recognizes but cannot always accommodate many of the limitations of the check processing operation.

Impact of The Act on Consumers

Regulation CC was characterized by ABA's recent Regulatory Burden Study as "the most burdensome regulation since Truth-in-Lending." Yet, the benefit to consumers appears to have been minimal, and most consumers perceive little positive impact from the law.

A survey reported in the Federal Reserve Board's "1989 Report to Congress Under the Expedited Funds Availability Act" found that none of the depository institutions surveyed indicated that their funds availability policy before Regulation CC was generally longer than the schedules required by the Act. This is consistent with a survey conducted in the fall of 1988 by the Banking Administration Institute which found that the policies of most banks after Regulation CC are similar to those they followed before the regulation. The 1989 consumer survey of the American Banker (an independent trade publication not affiliated with ABA) indicates that "consumers perceived little impact from the legal change."

Check Fraud Associated With Regulation CC

Another cost implication of the Act relates to fraud. Although it is difficult to quantify exactly, it appears that since passage of funds availability legislation, losses from uncollectible checks have risen.

Figures measuring check fraud losses are difficult to compile for a variety of reasons. For example, different depository institutions report such losses differently. Some depository institutions assign losses from uncollectible checks to the same category that they assign other losses of the depository institution. In addition, even if a depository institution does isolate losses from uncollectible checks, it may be difficult to attribute losses specifically to the funds availability legislation.

Nevertheless, individual depository institutions report an increase in losses from uncollectible checks since passage of funds availability legislation. For example, one large east coast bank has found that in the six years since passage of its state law, followed by the Act, its losses from uncollectible checks has tripled. Half of the losses are attributable to new accounts.

A serious concern with regard to fraud is that these losses will rise even more after the permanent schedules become effective this September. Passage of basic banking legislation may compound the problem. Currently, depository institutions must make funds from local checks available by the third business day, and funds from nonlocal checks by the seventh business day, following deposit. (Certain checks such as government checks and cashier's checks must be available on the day following deposit.) In September, these schedules will be shortened so that local

checks and nonlocal checks must be available on the second and fifth days following deposit, respectively.

While the return item process has improved since implementation of Regulation CC, uncollectible checks will often not be returned within the shortened time periods of the permanent funds availability schedule. Consequently, depository institutions will not know that a check is uncollectible before it must release its funds. Individuals can use this weakness in the system by depositing unpayable checks and withdrawing funds before the depository institution learns that they are uncollectible. Such a system is easily exploited, particularly if individuals could open accounts at numerous institutions under a basic banking law. Early availability and access to multiple accounts facilitates check kiting and other types of check fraud.

Major banks have provided us with copies of a "Guide to Check Cashing Fraud" pamphlet circulating on the west coast. Mr. Chairman, I have copies here of such a pamphlet for you and your staff, but prefer it not be included in the record or distributed. The guide demonstrates a fair knowledge of the payment system and relies on the use of the funds availability schedules.

The vulnerability of the system under the permanent schedules will be compounded by the the current definition of new account. New account under the Act means an account which has been opened in the last 30 days. This means that, after 30 days, deposits into the account must be available according to the statutory schedule. Thirty days, however, is not sufficient time for a depository institution to gain full confidence in the accountholders' ability or interest in properly managing an account. Experience has demonstrated that accounts most likely to have problems with overdrafts and uncollectible checks are those which have been opened within 6 months.

The potential for check fraud may also multiply under the permanent schedules if basic banking legislation is passed. Under current bills, virtually anyone may insist on opening an account, regardless of their financial history. These bills allow no discretion to enable depository institutions to reject an applicant based on knowledge that the applicant in the past has mismanaged or abused an account or even defrauded an institution. Thus, individuals may open several accounts and, relying on the availability schedules, defraud depository institutions by depositing uncollectible checks and withdrawing the funds before the bank can learn of their uncollectibility.

Amendments

Although amending the Act will not eradicate all risks associated with the funds availability schedules, we recommend several amendments to reduce these risks. In addition, we offer suggestions to accommodate the operational limitations of check

processing and other technical amendments. None of the amendments is intended to alter the substance of the Act. The amendments are discussed briefly below. Recommended language and more extensive explanations are attached to the statement.

The first amendment limits next-day availability on certain checks to the first $5,000 and applies other exceptions to the next-day availability schedule. The amendment, for example, allows depository institutions the discretion to release only the first $5,000 of a government check or cashier's check (or similar check) on the day following deposit.

Currently, banks must release all funds from such checks on the day following deposit -- regardless of the amount of the check, whether or not the check had been deposited and returned unpaid, or (except in the case of cashier's and similar checks) whether or not the depository institution believes the check to be uncollectible. Because it is very difficult for banks to determine the authenticity of checks within the short time frame between time of deposit and time of release (one day or less), an individual may deposit a large check and withdraw the funds on the following day, even if the check is uncollectible. It should also be noted that both the original Senate-passed and House-passed bills incorporated the provisions of this amendment, but they were deleted in conference.

The second amendment modifies the permanent availability schedule for deposits into shared automated teller machines ("ATM"). Under the permanent availability schedule of the Act, funds deposited into shared ATMs must be available according to the type of check deposited. Due to operational limitations which do not allow depository institutions to distinguish among types of checks, all such deposits, in effect, must be available on the second day following deposit. For example, the ATM cannot distinguish a government check which must be available on the day after deposit from a nonlocal check which must be available on the fifth day following deposit. The abbreviated availability schedule significantly increases the risk that funds will be released before the customer's institution can learn that the check is uncollectible.

In many cases, the only practical and prudent alternative for depository institutions is to discontinue accepting deposits into shared ATMs, eliminating a valuable customer service. Depository institutions in states where branching is restricted such as Illinois, rely heavily on shared ATMs to serve their customers and will be particularly affected absent an amendment.

The third amendment eases some of the compliance burden. It permits depository institutions to provide one-time notices when funds will be held beyond the statutory schedules. The one-time notice of exception to the schedule would apply, for instance, in cases when the reason for the exception is that an account is repeatedly overdrawn or the deposit is large. The amendment reduces paperwork for the depository institution and does not

affect customers as they will be informed when funds will be available.

The fourth amendment extends the period during which an account is considered "new" from 30 days to 6 months. The definition of "new account" is significant because banks generally may exempt deposits made into new accounts from the availability schedules funds.

New accounts are more susceptible to losses because perpetrators of fraudulent check schemes rely on multiple accounts held by persons not long or well known to the bank and on the ability to withdraw funds before the bank knows the checks are uncollectible. Indeed, one bank which found a significant increase in losses from uncollectible checks since implementation of funds availability legislation reports that 50 percent of such losses derive from new accounts.

A fifth amendment requires depository institutions to treat credit union share drafts payable through a bank as local or nonlocal based on the location of the bank through which the draft is payable rather than on the location of the credit union. This current regulation creates a significant operational obstacle because institutions must rely on the routing number in order to determine the length of the permissible hold in an automated manner. Because the machine readable routing number on payable through drafts identifies the payable through bank and not the credit union, a financial institution cannot rely on the MICR routing number to determine whether a check is local or nonlocal in an automated environment. Instead, they must review the checks manually. Chase's position on this amendment differs from the position of ABA and CBA.

The two remaining amendments are relatively minor. One explicitly subjects state and local governments on which checks are drawn to the liability rules for violations of the Federal Reserve's check collection and return regulations. The other amends the Act so that U.S. Treasury checks deposited into ATMs are treated in the same manner for purposes of funds availability schedules as other "next-day availability" items.

* * * * * * *

Mr. Chairman, we appreciate the opportunity to testify today and will be happy to answer any questions.

ATTACHMENT I

AMENDMENT TO
COMPETITIVE EQUALITY BANKING ACT OF 1987
P.L. 100-86

Section 604 is amended --

(1) in subsection (b), by inserting "(a)(2)," after "subsection";

(2) in subsection (c), by striking "(F)" after "subsections (a)(2)";

(3) in subsection (d), by inserting "(a)(2), after "subsections".

PURPOSE: To limit next day availability on certified and similar checks to $5,000 and apply other exceptions to the next day availability schedule.

EXPLANATION: This amendment expands the applicability of the exceptions to the availability schedules to checks that must be given next-day availability. Under the Act, a depository institution must make the entire proceeds of certain check deposits available for withdrawal at the start of the next business day following deposit irrespective of the amount of the deposit, the fact that the check being deposited had previously been return unpaid, or (except in the case of depository checks) the fact that the institution has reasonable cause to believe that the check being deposited is uncollectible. The exceptions to the schedules, which are available for other check deposits, should also apply to next-day checks in order to control the risk of fraud which may result from the unavailability of these exceptions.

It should also be noted that both Senate-passed and House-passed bills incorporated the provisions of this amendment, but they were deleted in conference.

ATTACHMENT II

AMENDMENT TO
COMPETITIVE EQUALITY BANKING OF 1987
P.L. 100-86

In Section 603 (e) (2), delete all of subparagraph (A) and in its place insert:

> (A) IN GENERAL---Not more than 4 business days shall intervene between the business day a deposit described in subparagraph (1)(B) is made at a nonproprietary automated teller machine (for deposit in an account at a depository institution) and the business day on which funds from such deposit are available for withdrawal.

Delete all of paragraphs (e)(2)(B) and (e)(2)(C).

Delete (e)(2)(D) and substitute (e)(2)(B)

PURPOSE: To modify the permanent availability schedule for deposits into shared ATMs so that all deposits into shared ATMs under the permanent schedule are treated as nonlocal items as they are under the temporary schedule.

EXPLANATION: The amendment modifies the availability schedules under the permanent schedule for deposits into shared ATMS. The amendment treats deposits into shared ATMs under the permanent schedule as they are treated under the temporary schedule that is, as nonlocal items. Funds from deposits into shared ATMs must thus be available by the fifth day following deposit under the permanent schedule.

Given the operational limitations of ATM equipment in a shared ATM environment, the result under the permanent schedule is that nearly all deposits into shared ATMs will be available on the second day following deposit, significantly increasing the risk that funds will be released before the customer's bank can learn that the check is uncollectible. Such a situation increases the bank's risk of loss from unpaid checks and fraud activity.

Unlike deposits into proprietary ATMs, the depository institution does not have the opportunity to ascertain the contents of deposits into a shared ATM. Deposits into shared ATMs are removed and processed by the servicer rather that by the account-holding institution. The servicer verifies the contents and prepares the deposits for collection. The servicer then forwards an electronic message to the customer's institution indicating the date, location, account number, and aggregate amount of the deposits as entered by the depositor. The customer's institution posts the amount to the customer's account, but never has possession of the actual deposit. Thus, the customer's institution cannot apply differential holds or

invoke an exception because it cannot ascertain the composition of the deposit.

Under the temporary schedule, banks may treat all deposits into shared ATMS as though they are nonlocal items. Under the permanent schedule, however, the availability schedules for deposits into shared ATMs are the same as those for proprietary ATMs, that is, government checks and similar items and local checks must be available on the second business day and nonlocal checks on the fifth business day. Because operational constraints do not practically allow the customer's bank to ascertain the composition of the checks, the bank must give all checks deposited into a shared ATM second day availability, even if they are nonlocal. Thus, depository institutions will be releasing funds long before they will be able to learn of their uncollectibility. The early availability for nonlocal checks invites abuse and fraud.

For many depository institutions, the practical and prudent alternative to assuming such risk is to discontinue accepting deposits from shared ATMs, depriving customers of a valuable service. Banks in states where branching is restricted will be particularly affected absent an amendment to the Act. The ultimate impact of the current provision will be denial of deposits into ATM networks because the extra customer service does not justify the risks associated with releasing funds much sooner than the bank can learn that they are uncollectible.

ATTACHMENT III

AMENDMENT TO
COMPETITIVE EQUALITY BANKING ACT OF 1987
P.L. 100-86

In Section 604(f)(2)(c) insert "(b)," after "subsection".

PURPOSE: To allow depository institutions to provide a one-time notice that deposits are excepted from the schedules for a specific period of time when: (1) the deposit is in excess of $5,000, or (2) the check is deposited into an account which is already repeatedly overdrawn.

EXPLANATION: This amendment permits depository institutions to mail a one-time notice of exceptions to the schedule which applies to all designated deposits made within a specified period when the reason for the exception is a repeatedly overdrawn account or large deposit.

Providing notice each time a depository institution invokes either the repeated overdraft or large dollar exception as currently required, is burdensome for the banks and tedious for the customer. The requirement is impractical and expensive to the extent that the exceptions themselves may be of very little practical value. A one-time notice does not harm customers; they will know of the exceptions and when funds will be available. Yet, the provisions will reduce depository institutions' burdens.

ATTACHMENT IV

AMENDMENT TO
COMPETITIVE EQUALITY BANKING ACT OF 1987
P.L. 100-86

In Section 604(a), delete the words "30-day period" and insert "6-month period" in its place.

PURPOSE: To extend the period during which an account may be considered"new."

EXPLANATION: This amendment extends from 30 days to 6 months the period during which an account is considered "new." Depository institutions generally may except from the availability schedules funds from deposits made into new accounts.

Releasing funds from checks deposited into new accounts before a depository institution knows them to be collectible is a matter of great concern. Historically, depository institutions have considered new accounts to be an area of great exposure and accordingly have posed special access restrictions on items deposited in accounts held by persons with whom the depository institution lacks any experience. Traditionally, banks have reviewed accounts with under six months experience as "new."

New accounts pose risks because the depository institution does not know new account holders. The depository institution has no experience or relationship with the new account holders on which to base confidence in their ability or interest in managing an account. New accounts are more susceptible to losses because perpetrators of fraudulent check schemes rely on multiple accounts held by persons not long or well known to the depository institution and on the ability to withdraw funds before the depository institution knows the checks are uncollectible, the latter which exists by virtue of the Act.

The amendment reduces the depository institution's unfair liability exposure posed by new accounts opened.

ATTACHMENT V

AMENDMENT TO
COMPETITIVE EQUALITY BANKING ACT OF 1987
P.L. 100-86

Section 602(17) is amended to read as follows:

> The term "originating depository institution" means the branch of a depository institution on which the check is drawn or through or at which a check is payable, as prescribed by regulations of the Board.

PURPOSE: To modify the Act so that checks and drafts are deemed local and nonlocal depending on the location of the institution to which the check or draft must be presented in order to receive payment.

EXPLANATION: A July, 1988 U.S. District Court decision ruled that a check is deemed local or nonlocal for purposes of the funds availability schedule depending on which bank issues the check, not the one to which it must be sent to for payment. Thus, under the court's decision, a California bank which accepts a check issued by another California institution must treat the check as local and subject to local availability schedules, even though that check must travel to a New York institution for payment and logically should be subject to nonlocal schedules. Consequently, under these situations, the bank accepting the check for deposit is at much greater risk that it will release funds which ultimately are uncollectible.

The routing numbers on checks are based on the location of the institution to which the check is sent for payment. Generally, depository institutions use machines to read these routing numbers to assign availability, distinguishing between local and nonlocal checks. Because of the court decision, depository insitutions are may no longer rely on the routing number encoded on the machine readable MICR line to sort local and nonlocal checks. Instead, personnel in depository institutions must review each item visually to determine from printed information which is not machine readable whether the time is local or nonlocal. Such an exercise slows check processing, contrary to Congress' expressed intent in the Act that the Board take steps to modernize and accelerate the check payment system.

ATTACHMENT VI

AMENDMENT TO
COMPETITIVE EQUALITY BANKING ACT OF 1987
P.L. 100-86

In section 611(f) add the words "or other entities participating in the payments system, including states and political subdivisions thereof on which checks are drawn." after the words "depository institutions."

PURPOSE: To subject explicitly state and local government on which checks are drawn to liability rules for violations of the Board's check collection and return regulations.

EXPLANATION: The statute provides the Federal Reserve Board with the authority to allocate liability for losses, such as those resulting from the mishandling of a returned check, among depository institutions. Other entities, however, are involved in the collection and payment of checks. These entities include states and their political subdivisions, which often issue warrants drawn directly on themselves to pay employees, vendors, pensioners, and those receiving public assistance. However, the Act does not clearly authorize the Board to allocate liability for losses, such as those resulting from the mishandling of a returned check, among entities such as states or local governments. Th# amendment eliminates the ambiguity of the statute by explicitly subjecting all entities participating in the payments system, including state and local governments, to liability rules for violations of the Federal Reserve Board's check collection and return regulations.

ATTACHMENT VII

AMENDMENT TO
COMPETITIVE EQUALITY BANKING ACT OF 1987
P.L. 100-86

In section 602(a)(2)(A), insert after the words "(ii) is endorsed only by the person to whom it was issued," the words, "(iii) is deposited in a receiving depository institution which is staffed by individuals employed by such institutions."

Delete "and" from subpart (i).

Delete "." from subpart (i) and insert ". and".

PURPOSE: To subject to the next day availability schedule only those U.S. Treasury checks deposited at manned teller stations.

EXPLANATION: This amendment deletes the requirement that U.S. Treasury checks deposited into proprietary ATMs must be available on the day following deposit. The amendment adds to the general next day availability of these checks the requirement that the deposit be made at a staffed teller station. This qualification already applies to all other checks subject to the next day availability schedule.

Because banks do not distinguish among types of deposits made into proprietary ATMs, they must treat all deposits as next day availability items and under the Act, release funds on the day after the deposit. Otherwise, they must discontinue accepting deposits into proprietary ATMs.

Generally, banks rely on automated and electronic adjustments to the account when a deposit is accepted through an ATM. Usually, the ATM "memo posts" the account, meaning the deposit appears on the account, but is not yet available for withdrawal until after verification of the contents. The person who collects the checks, or the balancer, reviews the contents of the deposit and compares them with audit trail tape of the ATM. Once the contents are verified, the balancer delivers the deposited items for processing.

On occasions, the balancer may place holds, but normally neither the ATM not the balancer identifies deposits as government checks. They do not distinguish because the only way to separate the various deposits is to review the ATM deposits manually and note the type of deposit into each account, a very time-consuming and costly exercise. It necessitates accessing

each account individually and applying a constant hold period rather than merely simultaneously crediting each account.

Usually, banks apply the same funds availability schedule to all types of ATM deposits. For example, the bank may release funds on the second day after deposit whether the deposits are from cash, local checks, or nonlocal checks. However, if the bank must make funds from U.S. Government checks available on the day following deposit, it must either allow next day availability on all deposits or distinguish among cash and the various types of check deposits.

Assigning next day availability to all deposits, including local and nonlocal checks, reduces the opportunity for banks to review checks in order to place appropriate holds. In addition, depending on the time ATM deposits are collected and the bank's process ATM deposits before that day's transit deadline. Consequently, customers depositing into an ATM will receive credit before the check is even sent for collection. The restriction may also attract those seeking to abuse short holds.

Accepting deposits into ATMs is already an expensive transaction because of processing costs. Requiring manual review and subsequent adjustments into accounts will serve to discourage this service, denying customers a valued convenience.

Senator DIXON. Thank you, Mr. Wittman. We will get back to some questions at the conclusion of all of the testimony.

Mr. Cole.

STATEMENT OF STEPHEN S. COLE, PRESIDENT, CASH STATION, INC., CHICAGO, IL, REPRESENTING THE ELECTRONIC FUNDS TRANSFER ASSOCIATION

Mr. COLE. I am vice chairman of the Washington, DC based trade association, the Electronic Funds Transfer Association, and I am president and chief executive officer of Cash Station, Inc., a Chicago-based automated teller machine network owned by close to 400 financial institutions in the State of Illinois.

The Electronic Funds Transfer Association is the only multi-interest trade group composed of domestic and financial institutions, credit card companies, retailers, telecommunications providers, equipment manufacturers and bank-owned ATM networks such as Cash Station, all of whom who have a profound interest in the development of electronic funds transfer business and, clearly, the laws that affect it.

I appreciate being given the opportunity to testify before you today to offer our views on the Expedited Funds Availability Act.

We are here to request that this committee provide for change in the permanent availability schedule of the act as it applies to non-proprietary, commonly known as shared ATM's.

If the current permanent availability schedule for deposits made at shared ATM's becomes effective on September 1, 1990, financial institutions and ATM networks subject to that act must either accept increased business risk due to the potential for exposure to incremental fraud, or remove an important and convenient banking service affecting millions of consumers on a nationwide basis. Importantly, as we have just heard the Federal Reserve Board of Governors proposes, the same change in availability schedules which they first offered in October 1989, to allow for continued deposit-taking at shared ATM's, we are fully supportive.

Specifically, we urge Congress to change the permanent schedule to treat all nonproprietary ATM deposits the same as nonlocal checks that must be made available no later than the fifth business day after the deposit.

Then the consumer can decide whether to make a deposit at a convenient ATM owned by a depository institution other than his or her own institution, or can make the deposit at a proprietary ATM or bank branch, where a marginally shorter availability period would apply.

In a shared ATM network environment, when a deposit is made by a customer of institution A to an ATM owned by institution B, institution A never learns the nature of the contents of the deposit unless the check is returned.

The reason for this is that institution B services the ATM. It checks the deposits to other institutions against the amount entered by the institution's depositor or customer, and then enters those items into the normal clearing process for collection.

Therefore, institution A has no way to determine availability periods for individual items on such a deposit.

Congress recognized this and passed the act in 1987 treating all deposits at nonproprietary ATM's in the temporary schedule the same as non-local checks.

Congress expected, however, that technological advances would make it possible, by September 1 of this year, for depository institutions to ascertain the nature of the items in a nonproprietary ATM deposit, so the permanent schedule treats such deposits the same as deposits made otherwise, except that no deposit item need be available earlier than the second business day after the day of deposits.

Unfortunately, there is not the technology today, nor will there be in the foreseeable future that will allow a depository institution to learn the contents of a deposit made by their customer at an ATM they don't own.

Senator DIXON. May I interrupt you at this point?

Mr. COLE. Yes, sir.

Senator DIXON. Will others here dispute that the statement you are making is a factual one?

Mr. COLE. I have seen some testimony, Mr. Chairman, that would indicate so. But I would like the opportunity——

Senator DIXON. That's the second time I have heard it today, and I wonder if it is a fact or your assertion.

Mr. COLE. To specifically answer that, IBM has developed a machine that will do that. They have sold approximately 100 of them in the entire United States of America. There are 75,000 ATM's in the United States today, none of which, with the exception of those number that I mentioned can do it.

So, if Congress would like a technological change to this, it would require the replacement of 75,000 automated teller machines in this country, at an average cost of $40,000 per machine.

Senator DIXON. Forgive me for interrupting. We will develop it more in a little while. Go right ahead. Pardon me.

Mr. COLE. Consequently, the only way an institution will be able to make sure it is in compliance with the act, after September 1, is to give availability on all such deposits by the second day after the deposit.

The industry's experience in doing so this past year has shown that the risk of loss is real when availability is given too early.

I will give you two examples of Financial Institutions in Illinois who voluntarily went to the permanent schedule in advance of next September 1. One of these institutions had a customer make a $13,000 deposit of a check into a nonproprietary ATM, meaning an ATM that the institution didn't own on August 1st. On August 2, the day after the deposit, that customer went to a teller window and cashed a check for $3,000. On August 3, the same customer went back to the same teller and cashed a check in excess of $2,500. And on August 4, the financial institution, who had received the deposit through the nonproprietary ATM, was informed that the $13,000 check was not good, which meant that the institution was exposed to a loss in excess of $5,000.

Another example involves a multibillion dollar Financial Institution one with sophisticated computer systems designed to help prevent such fraud. Despite this ability, fraud losses over the last year increased significantly, by 101 percent, after it adopted early the

permanent availability schedule. These losses were in excess of $500,000.

In view of such experiences, many depository institutions in ATM networks may find themselves, after September 1, with no alternative other than to remove what has become a very convenient customer service.

The impact of such cessation on customers would be substantial. A survey of shared ATM networks conducted by the Electric Funds Transfer Association indicates that 17.5 million cardholders can or do make deposits at shared ATM machines that are owned by another financial institution.

In 1989, over 4,500 network members, including banks, savings and loans, credit unions, processed more than 32 million deposit transactions of this nature, representing a dollar value in excess of $14 billion.

The average deposit amount of $450 is certain evidence that the shared ATM deposit function is important to the average consumer. The consumer certainly would be very disappointed if he or she could no longer after September 1, make a deposit into his or her bank, thrift or credit union, which is located across town or at an ATM convenient to home or work.

Importantly, our proposed amendment is for the purpose of maintaining the current level of consumer convenience, not reducing it.

The consumer will continue to have a choice when it comes to the availability of his or her funds.

If faster access to their deposit is necessary, the consumer can make their deposit with a teller or an ATM owned by their financial institution.

In summary, we are requesting that Congress accept our recommendation and the recommendation of the Board of Governors of the Federal Reserve and amend the Expedited Funds Availability Act to provide for treatment of deposits in nonproprietary ATM's in the same manner as they are today, specifically, that these deposits be made available the same as non local checks, that is, no later than the fifth business day following the deposit.

Speaking on behalf of the members of the Electronic Funds Transfer Association, I would like to extend my gratitude to you, Mr. Chairman, for your indulgence and I would be more than happy to answer any questions at your convenience.

[The complete prepared statement of Stephen S. Cole follows:]

STATEMENT

of

STEPHEN S. COLE

on behalf of the

ELECTRONIC FUNDS TRANSFER ASSOCIATION

before the

SUBCOMMITTEE ON CONSUMER AND REGULATORY AFFAIRS

UNITED STATES SENATE

on

EXPEDITED FUNDS AVAILABILITY ACT OVERSIGHT

March 1, 1990

Mr. Chairman and members of the Subcommittee:

My name is Stephen S. Cole. I am vice chairman of the Washington, DC, trade association, the Electronic Funds Transfer Association (EFTA), and President and Chief Executive Officer of Cash Station, Inc., a Chicago-based automated teller machine (ATM) network. The Electronic Funds Transfer Association is the only multi-industry trade group composed of domestic and international financial institutions, credit card companies, retailers, telecommunications providers, equipment manufacturers, and bank-owned ATM networks all of which have profound interest in the development of the electronic funds transfer business and laws that affect it.

I appreciate being given the opportunity to testify before you today to offer our views on the **Expedited Funds Availability Act.** I am here to request that this Subcommittee change the permanent availability schedule of the Act as it applies to nonproprietary, or shared, ATMs. If the permanent availability schedule for deposits made at shared ATMs becomes effective on September 1, 1990, the financial institutions and ATM networks either must accept the increased business risk due to exposure to fraud or remove an important and convenient banking service affecting millions of consumers nationwide. Importantly, the Federal Reserve Board of Governors proposed the same change in the availability schedule in October 1989 to allow for continued deposit-taking at shared ATMs, of which we are fully supportive.

The following describes how shared ATMs and shared ATM networks function today, particularly with respect to deposit-taking.

ATMs and Their Use

Typically, a customer at an ATM may withdraw cash from a deposit account, transfer funds between various deposit accounts, withdraw cash against a credit card line of credit and determine a deposit account balance. While not so common, customers may deposit checks and cash at many ATMs. The shared ATM networks of EFTA make it possible to receive these services at thousands of ATMs. A customer of a network member may use the ATMs owned and operated by all the members of the network. For example, Cash Station has more than 2.2 million cardholders, 400 bank, thrift and credit union members and over 2300 shared ATMs in the Chicago Metropolitan six county area and in downstate Illinois. A customer of any of its members may use almost any of the 2300 ATMs to withdraw cash and make deposits.

The extent to which customers of one institution use the ATMs of another is evidenced clearly by Cash Station's experience. Such transactions are referred to as interchange transactions and nonproprietary ATM transactions. During 1989, we processed over 60 million interchange transactions including 7 million which were deposits, representing nearly $5 billion. As large as these numbers are, and we are quite proud of the use our cardholders make of our network, there are four other regional networks that are even larger than Cash Station.

The EFT Association surveyed its shared ATM network members and the resulting information is found in Appendix I. The networks responding to this survey represent over 4500 financial institutions. In 1989 these institutions processed more than 32 million interchange deposit transactions with a value in excess of $14 billion. Today, more than 17.5 million cardholders can or do take advantage of this important network feature.

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Clearly, the interchange deposit feature is a service expected and used by average consumers in many parts of the country. Consumers, undoubtedly, will be very disappointed if they no longer are able to use the ATM most convenient to their home or work to make deposits into their bank, thrift or credit union which may be across town. This is likely to be the case after September 1, 1990, unless the law is changed. And without such a change these millions of satisfied customers will certainly demand a reason for the discontinuance of a service to which they have become accustomed.

Expedited Funds Availability Act

Congress crafted the availability schedules of the Act keeping in mind both the interests of consumers and the safety and soundness of depository institutions. In the temporary schedule, it took into account the fact that if a deposit is made at an ATM owned by an institution other than the depositor's bank, thrift or credit union the contents of the deposit never will be seen by the depositor's institution unless a check is returned. Since it would not know the contents of the deposit, the depositor's institution would be unable to apply the various time frames of the Act which are based on the type of items deposited. Therefore, Congress in the temporary schedule required the same availability on deposits made at another institution's ATM (referred to in the Act as a nonproprietary ATM) as it required in the case of nonlocal checks, the longest period of six intervening days.

In setting the permanent schedule, however, which becomes effective on September 1, 1990, Congress acted on the expectation that technological advances would solve the problem of a depository institution not knowing the contents of a deposit made at a nonproprietary ATM. Consequently, all ATM deposits were given the same time frames of availability as deposits made otherwise with the exception that no deposit made at a nonproprietary ATM need be available until the second business day after deposit.

Unfortunately, while there is technology to allow a depositor's institution to learn the contents of a nonproprietary ATM deposit, it is in extremely limited use and will take years to be fully adopted by the financial services industry. Therefore, as the law is written, depository institutions that receive such deposits after September 1, regardless of content, will have to make the funds available on the second day after deposit to assure compliance with the law. Such availability will pose a serious threat of loss to depository institutions that continue to offer such deposit service. Current loss experience and this threat of future losses could likely result in consumers losing the ability to make deposits at ATMs owned by institutions other than their own.

Federal Reserve Board Report

The Board of Governors of the Federal Reserve System recognizes this risk and the probable reaction of many depository institutions to it -- namely to cease to accept interchange deposits. In its **Report to Congress on Deposits at Nonproprietary Automated Teller Machines** dated October 31, 1989, the Board recommends that "Congress amend the Act to treat nonproprietary ATM deposits under the permanent schedule in the same manner as they are treated under the temporary schedule; i.e., require that deposits made at nonproprietary ATMs under the permanent schedule be made available for withdrawal as if they were nonlocal checks (not later than the fifth business day following the day of deposit)."

The Federal Reserve Board in its Report continued:

> This would help ensure that deposit-taking at nonproprietary ATMs is not restricted or discontinued by those banks that believe they need the flexibility to place longer holds on these deposits to limit their risk exposure. If such amendment were enacted, consumers would continue to be able to choose between the convenience of making a deposit at a nonproprietary ATM and the marginally prompter availability that may be provided if the deposit were made by other means.

EFTA fully supports the recommendation of the Federal Reserve Board.

Loss Experience

Experience during the past year has shown that the risk posed by nonproprietary ATM deposits is very real if funds are made available too quickly. A number of depository institutions have already implemented the permanent schedule. One financial institution that did so received a $13,000 deposit at a nonproprietary ATM on August 1, 1989. On August 2, the depositor cashed a $3,000 check at the teller window. On August 3, the depositor cashed a $2,553.52 check at the same teller facility. On August 4, the financial institution was informed by the institution that owned the ATM in which the deposit was made that the $13,000 check was being returned.

Another example of the real effects that adoption of the permanent schedule might have on the continuing viability of shared deposits involves one of Cash Station's largest banks, a bank with sophisticated computer systems to help protect against deposit fraud. This particular institution adopted the permanent availability schedule at the end of 1988, but has since experienced a significant increase in fraud.

Although the bank had an 11% increase in its retail account base between 1988 and 1989, the gross fraud write-offs attributable to adoption of the permanent schedule increased 101% during this same time period. In fact, the average fraud loss per fraud case in 1988 was $2,420, whereas in 1989, it increased to $3,499. This institution's total fraud loss was in excess in $500,000. One's imagination does not have to go too far to estimate the extent to which this could become a major problem for financial institutions.

Due to the experience noted above, this particular institution is now in full support of the recommended change to the permanent schedule as proposed by the Federal Reserve Board.

The number of cases of fraud that become publicly known are few. Depository institutions normally do not wish to discuss them in public, because there is concern that such publicity will be instructive to those who would undertake such activities or will disclose measures taken to prevent future frauds. Thereby, thieves would be alerted to the security barriers that must be surmounted.

Practical Consequences for Depository Institutions Permitting Customers to Make Nonproprietary Deposits

Detailed in Appendix II is a discussion explaining the mechanics of ATM deposits and various methods proposed for identification of deposit content. As described in the Appendix, it is currently impossible to accurately ascertain the contents of a customer's deposit made at a nonproprietary ATM, and, therefore, the institution must award availability solely on trust. In order to assure compliance with the Act's permanent schedule a depository institution will have to assume that all items are subject to the shortest availability time frame, namely the time frame applicable to deposits of U.S.

Treasury checks and cash, and make all deposits at nonproprietary ATMs available on the second business day.

Smaller institutions that are unable to afford their own computer processing systems and that must rely on vendors may be at substantially greater risk because, for the most part, they may not have the systems sophistication to provide any of the safeguards against fraud that may be enjoyed by larger institutions. And as we mentioned in the earlier fraud experience by one of my network members, even these safeguards are not fail-safe.

If the law is not changed as recommended by the Federal Reserve Board to allow four intervening days before availability in the case of all nonproprietary ATM deposits, EFT networks and depository institutions may find themselves with no alternative other than to cease taking interchange deposits. This would significantly inconvenience millions of consumers who should have a choice between making a deposit at a depository institution teller window or at a convenient ATM where there may be a marginally longer availability delay.

Conclusion

The EFTA supports the change in the permanent schedule recommended by the Federal Reserve Board, that is, all deposits at nonproprietary ATMs should be treated as nonlocal checks with four intervening days after day of deposit before availability is required. Only through such a change can Congress assure that the Expedited Funds Availability Act does not adversely affect the consumer by causing the discontinuance of a deposit service now enjoyed by millions.

Such a change in the law, though the schedule is designated permanent, would not mean that availability of such deposits would never be required in less time than four intervening days. IBM and other hardware vendors will still be under market pressure to advance teller machine technologies for the many uses to which scanners and other developments may be put. Computer software developments, again driven by market pressures, may reduce risk of earlier availability. And market pressures on depository institutions could tend to bring earlier availability. Finally, under section 603(d)(1) of the Act (12 USC § 4002(d)(1)) the Federal Reserve Board is required when advancements occur to reduce the statutory time periods, by regulation, to as short a time period as is possible.

APPENDIX I

Survey of Customer Deposits Into Nonproprietary ATM Networks

The Electronic Funds Transfer Association conducted a survey of ATM networks whose members accept deposits into ATMs from customers of other member institutions. Eleven networks responded to this survey. They represent financial institutions and cardholders from the states of Colorado, Delaware, Florida, Idaho, Illinois, Indiana, Iowa, Kentucky, Michigan, Montana, Nebraska, New York, Ohio, Oregon, Pennsylvania, Washington, West Virginia, and Wisconsin. The following information is an aggregate picture taken from information provided separately by each network.

- Number of financial institutions represented by these ATM networks: 4,546
- Number of ATM machines accepting deposits from customers of another financial institution: 17,234
- Number of ATM cardholders who can or do make deposits into terminals not owned by their bank: 17,525,000
- In 1989, the number of deposits made by customers into terminals not owned by their financial institution: 32,100,000
- The total dollar value of these deposit transactions: $14,377,400,000
- The average number of monthly deposit transactions of this nature: 2,675,000
- The average deposit amount of each transaction: $450

Seven of the eleven networks operate in more than one Federal Research Board (FRB) district; one network operates in three FRB districts; two networks operate in four FRB districts; one network operates in five FRB districts.

Data compiled 2/23/90 EFTA

APPENDIX II
Mechanics of ATM Deposits

A brief discussion of ATM operations may help to bring this discussion together. A nonproprietary ATM deposit by a depository institution customer typically occurs as follows. The customer of institution A inserts his or her card into an ATM owned by institution B. The customer then enters a personal identification number and the information necessary to make the deposit. The items to be deposited are placed in a special deposit envelope made available at the ATM for that purpose and the envelope is inserted into the ATM. The deposit sets off at least four reactions (not necessarily in the following order):

A. Request for Authorization. The customer's account information (i.e., card number and personal identification number), the transaction type and the dollar amount are sent to the network computer, or "switch", and routed by the switch to depository institution A's cardholder file for authorization.

B. Settlement Between Institutions. Depository B pays to A the money deposited at B's ATM and collected by B.

C. Collection of Items Deposited. Depository institution B presents the items deposited by A's customer for collection after verifying the amounts of the items against the amount entered by A's customer. Depository institution A never sees or learns the nature of these items unless there is a problem with the deposit or with the collectability of checks.

D. Posting to Accounts. Depository institution A gives credit to its customer in the amount of the deposit.

As this brief summary demonstrates there presently is no mechanism by which depository institution A may learn from B the nature of the items deposited so that it may determine time of availability for the items according to the permanent schedule.

Possible Methods for Informing Depositor's Institution of Contents of Nonproprietary Deposits

A number of methods have been identified that would inform the depositor's institution, institution A, of the contents of a nonproprietary ATM deposit. These methods were discussed and discounted as practical solutions by the Federal Reserve Board in its October 1988 Report on Nonproprietary ATMs as well as in its October 1989 Report.

A. Post-Deposit Notification Methods

1. The depository institution that owns and operates the ATM, institution B, after servicing the ATM could inform A by telephone of the contents of A's customer's deposit.

2. B after servicing its ATM could make entries into a network computer regarding the items in all interchange deposits and the depositor's institution could ascertain such information whenever it so desired.

3. Each day B could deliver to the depositors' institutions the envelopes of each institution's depositors.

Each of these methods is time consuming and labor intensive. They would add significantly to the cost of processing nonproprietary ATM deposits. They each run totally contrary to the purpose of ATM deployment, that is, timely, efficient, less costly banking services. Moreover, given the practice of daily servicing, the time required for deposit-by-deposit handling and the number of institutions in a network along with

geographic dispersion, none of the foregoing methods would likely result in A learning the contents of a deposit at B's ATM until some time during the second business day after deposit, at the earliest, which may already be too late to comply with availability requirements for items other than nonlocal checks.

B. Methods for Notification at Time of Deposit

1. The depository institution that owns the ATM, B, could replace its ATMs with ones capable of reading MICR information from items deposited. This would involve replacing current machines, that normally cost between $25,000 and $36,000 and that have remaining useful lives with machines that cost about $70,000. In addition to machine replacement there would have to be software changes at every stage of the network.
   - The intercept processor for the institution acquiring the machines, B, would have to change its software for driving ATMs to comprehend the information collected by the ATM.
   - The ATM network switch would have to change its software to comprehend the information collected by the ATM and transmitted by B's intercept processor.
   - The processor for the depositor's institution, A, would have to change its software to comprehend the information collected by the ATM and transmitted by the intercept processor to the network switch.

The foregoing software adjustments perhaps might be justified on a cost basis if a significant segment of a network's ATMs had the capability to read MICR encoding on items deposited. But, at least in the Cash Station case, none of the 2300 shared ATMs has such capability. And the same is true for virtually all the other networks.

But even if we had the scanner machines in place throughout a network, the problem of lack of knowledge would not be solved. The MICR scanner will allow the depositor's institutions to determine whether the check is local or nonlocal provided it is not drawn on a credit union that pays its checks through a bank which may, or may not, be located in the same check-processing region as the credit union.

The Federal Reserve Board in its initial Regulation CC provided that the routing numbers on a check were determinative of whether it was local or nonlocal for availability purposes. A court, however, reversed the rule holding that the actual location of the credit union determines the question regardless of routing numbers and the location of the payable-through bank. Therefore, credit union checks that are included in deposits must be manually read to determine if they are local or nonlocal.

The MICR scanner ATM causes another problem. Each check must be fed through the scanner separately along with the deposit information thereon. The time required of customers to make deposits will increase significantly. So the MICR scanner of today is not a panacea.

2. Customers of a depository institution using another institution's ATM to make a deposit could be asked to enter at the time of deposit additional information regarding the nature and amount of the specific items deposited.

This method which implements an "honor system" has one major advantage over the previous alternative in that it would not require replacement of ATM hardware. But it would require software changes at the intercept processor, network switch and account processor in the same manner as the previous alternative. This method would subject the depositor's institution to considerable risk that the depositor, if he or she were unscrupulous and intent on fraud, would mischaracterize the deposit indicating the

shortest availability period. This method would require significant user education and is likely to result in an abundance of errors, especially in the case of deposits containing a variety of items. The only protection against such abuse and such errors would be for the institution that owns the ATM to review each deposit in detail against the information entered by the depositor. Again, such a review would be too time consuming and labor intensive to be a real solution.

Senator DIXON. Thank you, Mr. Cole.
Ms. RECTANUS.

STATEMENT OF MARGARET N. RECTANUS, VICE PRESIDENT AND ASSISTANT GENERAL MANAGER, CREDIT UNION PRODUCTS AND SERVICES, MADISON, WI, REPRESENTING CREDIT UNION NATIONAL ASSOCIATION, INC

Ms. RECTANUS. I'm vice president of the major trade association representing the Nation's 15,000 credit unions through our 52 State leagues.

We appreciate your invitation to appear. We have been asked to comment on the amendments the Federal Reserve Board recommended in reports to Congress last year.

We see some merit in four of the amendments contained in the June 1989 report to Congress. These amendments would enhance the implementation of the Expedited Funds Availability Act and would help financial institutions to protect themselves from fraud.

Since a Credit Union is a financial cooperative, the cost of fraud perpetrated by one member of a credit union is borne by all members.

We strenuously oppose one of the amendments, which would disadvantage almost 3,000 credit unions that rely on a national payable through share draft program, which has been in existence since the mid-1970's.

This system uses the Chase Manhattan Bank and four banks used by the Travelers Express Co. in Minneapolis to centralize share draft clearing.

The Expedited Funds Availability Act proposed that the Federal Reserve Banks provide for check truncation. The only successful consumer truncation system in the country is the credit union payable through share draft system.

Every one of the 2½ million credit union members using the national pay-through system uses a truncated account. Truncation is an important component in keeping costs down for credit union members.

Another cost-saving factor that puts us on the cutting edge of the paperless check system is that the payable through bank does not send the actual paper share draft on to the account-owning credit union to determine if it will be paid. Despite the advantages of the payable through system, its existence has been threatened by various proposals and regulation CC.

First, I would like to explain that CUNA was an early supporter of congressional efforts to curtail unnecessary holds on checks and to provide consumers with adequate information on when funds would be available for withdrawal.

CUNA never anticipated that its support for the passage of the EFAA would jeopardize the national payable through share draft system. The law is clear. The act defines a local originating depository institution as the originating depository institution located in the same check processing region as the receiving institution.

To explain how things unfolded, the Federal Reserve Board proposed in December of 1987 that whether a share draft is local or nonlocal for the purpose of determining holds would be determined

by the location of the payable through bank, not by the location of the account-holding credit union.

The former chairman and other members of the House Banking Committee wrote to the Board in early 1988 to state that its position contravened the act.

In May of 1988, the Federal Reserve Board issued a final regulation which retained its proposed language. CUNA was forced to sue the Federal Reserve Board and, in July 1988, the U.S. District Court ruled in CUNA's favor.

The Board conformed regulation CC to the court's ruling prior to the effective date but, later in 1988, sought comments on four possible alternative changes in regulation CC. CUNA objected to two of the proposals, one requiring a local routing and transit number in the MICR line, and another providing for direct presentment.

Both would have disadvantaged many small credit unions. CUNA did agree to conspicuous labeling requirement if the Board felt conspicuous labeling would assist consumers, and supported a Federal Reserve recommendation to shift the risk for any loss due to the time required for the return of an item from nonlocal payable through banks to the credit union on which the payable through item is written.

These events put into perspective the Federal Reserve Board's first recommendation made to Congress in the June 1989 report, the purpose of which was, and I quote:

> Resolve the operational and disclosure difficulties of the payable check through ruling cost.

The Board's recommendation specifically proposes an amendment to the act which would treat payable through share drafts as local or nonlocal items, depending on the location of the payable through bank.

We urge Congress not to consider such an amendment. If any amendment is considered, we urge it to be an amendment to clarify the current law on the treatment of payable through share drafts. A possible amendment to subsection 602.13 of the Expedited Funds Availability Act would read:

> The term "local originating depository institution" means any depository institution, including one whose checks are payable through another depository institution, which is located in the same check-processing region as the receiving depository institution.

The Federal Reserve Board makes their recommendation based on alleged, not proven, problems. In fact, both survey and anecdotal evidence indicate that upward of 80 percent of all banks provide next day or immediate availability on checks deposited.

For all of these banks, this is a nonissue. While there may be some theoretical concern about fraud, the average share draft is only $89 in size and fraud has not been evident in our system before or after implementation of regulation CC.

Having earlier accepted the Federal Reserve Board's regulatory proposals, we have shifted any risk from payable through losses from the nonlocal payable through bank to the credit union.

In addition, the new conspicuous labeling requirement adopted by the Board will make payable through share drafts the easiest items for consumers to decipher.

In fact, we think it is such a good idea, we believe that all depository institutions should have to reprint the front of all checks to make it easy for the consumer to ascertain whether an item is local or nonlocal.

One of the last points prior to the enactment was how to handle deposits at nonproprietary automated teller machines.

Financial institutions that participate in ATM's consider the final provisions adopted by Congress unworkable and hope that before the effective date of the permanent availability schedule, Congress will revisit this issue.

The Federal Reserve Board issued a report in October 1989 on the processing of deposits made at ATM's and the ability of systems to provide necessary information.

CUNA supports the recommendations made by the Board last October that the Expedited Funds Availability Act be amended to treat nonproprietary ATM deposits under the permanent schedule in the same manner as they are treated under the temporary schedule.

I appreciate the opportunity to be here on behalf of CUNA and I would be happy to answer any questions.

[The complete prepared statement of Margaret M. Rectanus follows:]

TESTIMONY OF

THE CREDIT UNION NATIONAL ASSOCIATION

BEFORE THE SENATE BANKING COMMITTEE'S

SUBCOMMITTEE ON CONSUMER AND REGULATORY AFFAIRS

ON OVERSIGHT HEARINGS ON

THE EXPEDITED FUNDS AVAILABILITY ACT

MARCH 1, 1990

I am Margaret N. Rectanus, Vice President of the Credit Union National Association and Affiliates Inc., CUNA, the major trade association representing the nation's 15,000 credit unions through 52 state leagues. CUNA appreciates the Subcommittee's invitation to appear to discuss our views on how the Expedited Funds Availability Act is working and what revisions might be needed in the law. We have been specifically asked to comment on the six amendments the Federal Reserve Board recommended in reports to Congress last year. CUNA strenuously opposes one of these amendments.

CUNA was an early supporter of Congressional efforts to curtail unnecessary holds on checks and share drafts deposited by consumers in bank, savings and loan, and credit union accounts and to provide consumers with adequate information on when funds would be available for withdrawal. While surveys indicated that a majority of credit unions imposed no holds, in 1983 and 1984 CUNA urged credit unions to consider the need for holds they might impose and clearly disclose their hold policies to their members. In early 1985 CUNA was one of the first financial trade groups to support the general legislative framework that was eventually enacted into the federal checkhold law in 1987.

The Expedited Funds Availability Act was enacted in August 1987, with disclosure requirements and initial hold periods effective September 1, 1988. The Federal Reserve Board, FRB, and its staff did an extraordinary job in working with the affected industry and consumer groups to formulate a comprehensive regulation under a tight timetable. Known as Regulation CC, this regulation limits holds, provides disclosures to consumers, specifies indorsement standards, and speeds the return of unpaid checks.

Considering the complexity of the checkhold law, implementation has not been overly disruptive. As did the other financial trade associations and the Federal Reserve System, CUNA held training seminars, produced a compliance manual, and disseminated other information to our member credit unions in order to assure that they would be prepared for the September 1, 1988 effective date.

Last summer, the Federal Reserve Board transmitted a report to Congress on the progress the Board has made in implementing the funds availability schedules and the impact on depository institutions. This report was required by the Expedited Funds Availability Act. That report concluded by making five legislative recommendations. The first of those recommendations is of great concern to 3,000 credit unions that rely on a national payable through share draft program which has been in existence since the mid-1970's.

Share draft accounts were developed to respond to consumer demands for convenient access to interest-bearing accounts. CUNA undertook the research and development of these new accounts, including defending the legality of these consumer share draft accounts from challenges. Credit unions did not have the volume or backroom operations to make check clearing and processing cost effective for individual credit unions. It made sense then, and for thousands of credit unions it makes sense today, to participate in what we term the national payable through share draft system. This system uses the Chase Manhattan Bank in New York City and four banks used by the Travelers Express Company of Minneapolis to

centralize share draft clearing.

This system contains two components that are on the cutting edge of the paperless check system. First, right from the start we believed that there would be consumer acceptance of truncation. We repeatedly hear that consumers will never accept a system that does not return checks to them. Every one of the 2.5 million credit union members using the national payable through system uses a truncated system. The consumer produces a carbon copy of the share draft when a share draft is written, and receives a monthly statement merely itemizing the drafts that have cleared. Truncation is an important component in keeping costs down for credit union members.

The other key component of our system is the fact that the payable through bank does not send the actual paper share draft on to the account-holding credit union to determine if it will be paid. Rather, the payable through bank electronically presents the item for payment, and the credit union electronically responds if it will not pay the share draft. Because of this feature, a share draft that may come from any part of the country into a centralized payable through bank can be paid as quickly as if it were presented locally by the depository bank.

This characteristic of the national payable through system is important in order to understand the significant problem credit unions using payable through share drafts had with Regulation CC as it was issued in mid-1988. The Federal Reserve Board proposed in December 1987 that whether a share draft is local or nonlocal (for the purpose of determining the length of possible holds) would be determined by the location of the payable through bank, not by the location of the account-holding credit union. CUNA and many credit unions strenuously objected that this proposal was contrary to the statute and could seriously impede the acceptance of share drafts in the local marketplace.

CUNA never anticipated that its support for the passage of the Expedited Funds Availability Act would jeopardize the national payable through share draft system. After all, the law is very clear. The Act defines the "local originating depository institution" as the originating depository institution "located in the same check processing region as the receiving institution." The former Chairman and other members of the House Banking Committee wrote to the Board in early 1988 to state that the FRB's proposal contravened the Act.

In May 1988 the Federal Reserve Board issued a final regulation which retained its proposed language categorizing share drafts as local or nonlocal depending on the location of the payable through bank. CUNA was forced to sue the Federal Reserve Board, and in July 1988 the U.S. District Court ruled in CUNA's favor. The Board conformed Regulation CC to the court's ruling prior to the effective date, but later in 1988 sought comments on four possible alternative changes in Regulation CC to:

(1) Require payable through items to bear a local routing number in the MICR line.

(2) Allow such items to be presented directly to the institution on which they are written.

(3) Require payable through items to be conspicuously labelled as payable through, specifying the name and location of the payable through bank and the name, location, and nine-digit routing number of the institution on which the check is written.

(4) Shift to the institution (i.e. credit union) on which the payable through item is written the risks of any loss due to the time required for the return on such checks from nonlocal payable through banks.

CUNA strenuously objected to the first two proposals, which would have required the dismantling of the national payable through system and/or forced credit unions to handle items outside of their normal operations. CUNA did, however, agree to the conspicuous labelling requirement if the Board felt conspicuous labelling would assist in compliance and if adequate time were provided for payable through share drafts to be reprinted. Moveover, CUNA felt that since virtually all payable through share drafts clear as quickly as any local items, there really is no additional risk, and therefore we supported the fourth FRB proposal. The Board declined to pursue the first two proposals cited above, but in July 1989 adopted the two proposals supported by the credit union movement. The shifting of the risk provision became effective February 1, 1990, and all share drafts using nonlocal payable through banks must be reprinted by February 1, 1991.

We review these events at length in order to put into perspective the FRB's first legislative recommendation made to Congress in its June 1989 report, the intent of which was to "resolve the operational and disclosure difficulties that the payable through check ruling has caused." The Board's recommendation specifically proposes an amendment to the Act which would treat payable through share drafts as local or nonlocal items depending on the location of the payable through bank. (This recommendation was made before the Board adopted proposals 3 and 4 above -- - one of which has only been in effect for 30 days and the other will not take effect until early next year.)

While there may be some theoretical concern about fraud, the average share draft is only $89 in size, and fraud has not been evident in our share draft system before or after implementation of Regulation CC. In fact, having accepted one of the FRB's 1988 proposals (number 4 above), we have shifted the risks for any loss due to the time required for the return on such checks from nonlocal payable through banks, to the institution on which the payable through item is written.

One reason the Board cited in its June 1989 for needing a statutory change was because "customers cannot rely on the routing number to determine whether the check is local or nonlocal, and thus cannot determine the hold applicable to that share draft." The conspicuous labelling requirement will make payable through share drafts the <u>easiest</u> items for consumers to decipher. In fact, we think it is such a good idea, we believe that all depository institutions should have to, after a reasonable transition period, re-print the front of all checks to make it easy for the consumer to ascertain whether an item is local or nonlocal.

We have always been surprised that the Federal Reserve Board adopted disclosure rules that require consumers to try to make heads or tails of the routing and transit number in the MICR line of a check. An item is local or nonlocal depending on whether the depository and paying institutions are in the same regional check processing center. The country is divided up into 48 of these check processing regions. We have suggested in the past a disclosure system for consumers that would require the front of each check to conspicuously contain a number 1 through 48. If the number of a check received by the consumer matched the number on the consumer's own checkbook, the individual would know that the check was local, and otherwise it was nonlocal. Therefore, the consumer would not have to memorize a string of numbers, but only learn his or her own depository institution's hold policies.

The Board has proposed an amendment which would force the dismantlement of the national payable through system, even though it notes that "most credit union payable through share drafts are deposited in accounts on which holds are not imposed...." We urge Congress not to consider such an amendment. If any amendment is considered, we urge it be an amendment to clarify the current law on the treatment of payable through share drafts. A possible amendment would amend Subsection 602(13) of the Expedited Funds Availability Act to read:

> "(13) Local Originating Depository Institution -- The term 'local originating depository institution' means any depository institution (including one whose checks are payable through another depository institution) which is located in the same check processing region as the receiving depository institution."

The Federal Reserve Board's June 1989 report to Congress contained four other amendments:

- **Expand the applicability of the exception holds to the availability schedules to checks that must be given next-day availability**: Depository institutions should have the ability to protect themselves from fraud. After all, the cost of fraud perpetrated by one member of a credit union is borne by all members, since a credit union is a financial cooperative. Deposits made in the form of cash or by wire transfer should continue to be provided next-day availability, but there may be some areas where the next-day availability rules present unreasonable risks to depositary institutions.

- **Limit the next-day requirement for Treasury checks and "on-us" checks to checks deposited at staffed teller facilities**: This change would be consistent with how the Act treats other next-day availability items. For example, if a cash deposit is not made at a staffed teller station, the receiving institution may delay availability until the second business day. Generally, it can be operationally impossible for the credit union to post items deposited to a proprietary ATM to a member's account in time for next-day availability.

- **Provide greater flexibility in the manner of giving notice to**

the depositor that an exception has been invoked: The Act gives the Board the authority to prescribe by regulation the notice requirements institutions must follow when a hold is placed on a deposit because of emergency conditions or to prevent fraud losses. Congress should allow the Board the same flexibility in establishing the notice requirements for the exceptions that apply to large dollar deposits or when there are repeated overdrafts. This change would have no effect on the way in which the consumer's deposit is treated.

- **Explicitly subject state and local governments on which checks are drawn to liability rules for violations of the Board's check collection and return requirements:** The Act now applies its check collection and return requirements to depository institutions. State and local governments participate in the payments system by issuing "warrants" drawn directly on themselves, which are deposited in credit unions and other depository institutions. It is important that the state and local governments be subject to all appropriate aspects of the Board's check collection and return requirements, so that consumers do not have to be concerned about the payment instrument they receive.

One of the last sticking points prior to the enactment of the Expedited Funds Availability Act in 1987 was how to handle deposits at non-proprietary automated teller machines. Financial institutions participating in ATM networks, including credit unions, considered the final provisions adopted by Congress unworkable, and hoped that before the September 1, 1990 effective date for the permanent availability schedule, Congress would revisit this issue. As required by the Act, the Federal Reserve Board issued a report to Congress in October 1989 on the processing of deposits made at ATMs, and the ability of ATM systems to provide information necessary to account-holding institutions to comply with the permanent availability schedules mandated by the Act. CUNA supports the recommendation made by the Board last October that the Expedited Funds Availability Act be amended to treat non-proprietary ATM deposits under the permanent schedule in the same manner as they are treated under the temporary schedule.

I appreciate the opportunity to appear here on behalf of CUNA, and I am happy to answer any questions.

# # #

Senator DIXON. I thank you.
Ms. Meier, we are glad to see you here.
Ms. MEIER. Thank you, Mr. Chairman.

STATEMENT OF MICHELLE MEIER, COUNSEL FOR GOVERNMENT AFFAIRS, CONSUMERS UNION OF UNITED STATES, INC

Ms. MEIER. We appreciate the opportunity to testify today, although, in many respects, I feel like this hearing is a deja vu. We worked a lot on the check hold legislation during the many years in which it was germinating and when it passed. And a lot of the arguments that I hear being raised today are the same arguments that we went through and either rejected—Congress either rejected, or accommodated when the law was passed in 1987.

We regarded the passage of the 1987 act as a long-overdue consumer victory and we are truly dismayed that these amendments that will unravel a lot of the protections the consumer got in that act are being proposed and considered, just as the major benefits of the act, which are due to take effect in September of this year, are about to be put in place.

We urge the committee to reject these amendments and to turn its attention to some of the other problems that have also received long consideration by the subcommittee and others, rather than addressing these undermining amendments.

Some of the factual bases of the 1987 act are required as preparatory remarks. First of all, the Congress through extensive testimony was aware when it passed the act that very, very few checks are ever returned. Less than 1 percent of all checks are ever returned. And even those that are returned, almost half of them are paid the second time through when they are presented a second time. And most checks that are returned are eventually collected on by the bank into which they are deposited.

In spite of these numbers, and as a background to these numbers, during the development of the legislation, the industry claimed that very few banks even placed holds on deposited checks. Less than 1 percent checks were held was the claim.

Given that environment, this "no holds" policy environment that the industry claimed was prevalent within the industry, we find the 1 percent, less than 1 percent return rate on all deposited checks to be extremely significant to show that a no holds policy, one that goes far beyond the requirements of the act, does not produce rampant fraud and check losses.

Another thing that Congress was aware of through extensive testimony when it passed the act was that the existing system, the one in effect before the changes produced by regulation CC, was not risk-free. There was already risk in the system.

Our testimony before Senator Proxmire in 1987 went through a lot of the various ways that those who really wanted to beat the system could beat the system. Part of that factual basis was a Fed study showing that large percentages of checks that are returned to the bank into which they are deposited long after even a long hold period expires.

So the purpose of the 1987 act, the goal of the act, was not to totally eliminate risk, but to protect consumers without significantly increasing risk. There's already risk in the system.

Another thing that Congress was aware of was that long holds produced hardships on consumers. This is particularly true for lower-income consumers who live from paycheck to paycheck. Part of the burden is inconvenience, but part of it is also cost. When consumers write checks against deposited funds that they believe will be almost immediately available and they are not immediately available, they suffer bounced check charges, inconvenience, and vendor charges on the returned checks.

So, Congress sought to eliminate that hardship. And also, in addition to reducing the hold period, Congress wanted to make sure that consumers know what the hold policy would be because part of the problem was just lack of information.

So, the notice provisions are very important.

In response to some of the things I have heard today and have heard for a long time on this regulation and law, one being the regulatory burden charge, that regulation CC and the act has imposed such a humongous regulatory burden on the industry.

Well, the regulatory burden that always accompanies legislation would not have been necessary had the years of calls for voluntary efforts in this area actually produced some results.

Also, some of the regulatory burden associated with this act has actually, as I said before, improved the check-clearing system. Many persons other than consumer groups had for a long time prior to the enactment of the act recognized and called for improvements to the system, which involved a very arcane return process. The check collection system was very arcane and cumbersome before the act passed. And now, because of the law, checks are getting back very quickly so that some of the losses that might have arisen before the law was in effect can be eliminated.

I have also heard a lot about costs today, which is the same thing that I heard in pre-1987 about the effect of this act. I have not seen any figures from the Fed or any other group that in any methodical way documents these increased costs. We only hear about "increased costs". I am sure there's always some cost to comply with a regulation. But, these repeated charges that there are humongous costs have been undocumented. The same is true about the claim of increased losses.

Previous panelists mentioned anecdotal circumstances producing increased losses resulting from the check-hold law. I would like to see some documentation of the direct nexus between the law and those losses.

I would also like to point out that there were losses before the act was put into effect. I could point to anecdotal situations where losses occurred even before the act was put into effect. And I don't think anecdotal loss information is proof that the law in itself is resulting in increased losses.

On the amendments, generally, we oppose them. We think there was a lot of effort, particularly during the few months preceding the final passage of this act, to really respond to some of the concerns raised by the proponents of the present amendments.

It is a very finely crafted piece of legislation, and the amendments that the industry and the Fed are describing as technical and necessary, we simply disagree that they are either technical or necessary.

On the proprietary/nonproprietary amendment, we feel particularly strong. The upshot of that amendment is that when the permanent schedule becomes effective, consumers depositing checks on Monday, for example, in a nonproprietary ATM, would have to wait until the following Monday to get access to those funds. Under the legislation, they would only have to wait one or two days. Not all consumers need access to every check they deposit immediately, but when they do, they need very quick access. So this is a significant increase in the time that consumers will have to wait to get access.

We go through some of the more technical reasons for our opposition to these amendments in our testimony.

And I would be happy to answer questions.

[The complete prepared statement of Michelle Meier follows:]

Consumers Union
Publisher of Consumer Reports

TESTIMONY OF

MICHELLE MEIER
COUNSEL FOR GOVERNMENT AFFAIRS
CONSUMERS UNION

before the

Subcommittee on Consumer and Regulatory Affairs
Committee on Banking, Housing and Urban Affairs
U.S. Senate

on

The Expedited Funds Availability Act
March 1, 1990

Consumers Union* appreciates the opportunity to testify today. After years of debate, the legislation that is the subject of this hearing[1] was enacted into law in 1987 with the strong support of my organization and many others. Now the industry would like to unravel that consumer victory by amending the law even before its most important protections are put into place. We urge this committee to oppose these amendments, which will increase the time period consumers must wait to get access to their deposited funds. We urge the committee to turn its attention to the many problems consumers face in the financial services marketplace, such as the need for affordable deposit account services, rather than undermining recently-won reforms.

* Consumers Union is a nonprofit membership organization, chartered in 1936 under the laws of the State of New York to provide information, education, and counsel about consumer goods and services and the management of family income. Consumers Union's income is derived solely from the sale of Consumer Reports, its other publications and films. Expenses of occasional public service efforts may be met, in part, by nonrestrictive, noncommercial grants and fees. In addition to reports on Consumers Union's own product testing, Consumer Reports, with approximately 4 million circulation, regularly carries articles on health, product safety, marketplace economics and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

[1] The Expedited Funds Availability Act, Title IV of Pub.L. 100-86, 101 stat. 522, 635, 12 U.S.C. 4001 et.seq.

Before going into the individual amendments, a brief discussion of the facts that formed the basis for the approach taken in the 1987 legislation is in order. First, while the legislation was being debated, the banking industry claimed that the vast majority of institutions did not place holds on deposited funds.[2] In spite of this, Federal Reserve data indicated that less than 1% of all checks are ever returned, and even almost half of these checks are paid when they are presented to the bank on which they are drawn a second time.[3] Thus, even a prevalent "no holds" policy, one that goes far beyond the requirements of the Act, does not lead to rampant check fraud or check losses. Indeed, it is ironic that the industry seeks to lengthen the hold periods required under the Act when it has claimed all along that most banks do not impose holds anyway.

Second, even long hold periods can not eliminate "bad check" risk.[4] Thus, the legislation did not seek to totally eliminate risk. Instead, it sought to protect consumers without significantly increasing risk.

Third, before the Act became law, the federal regulators reported that consumers complained to them more about check hold policies than any other banking problem.[5] Lengthy holds prevent consumers from accessing their own hard-earned money, an injustice that particularly burdens lower-income consumers who live from paycheck to paycheck. Lengthy holds can also cause embarrassment and costs from hefty returned check fees when the consumer is unaware that a hold has been placed and writes checks against the deposited funds. We estimated in 1987 that consumers lose $135 million each year from fees imposed when checks are returned because they were written against funds subject to a "hold."

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[2]Eg, Statement of Kenneth Glass, on behalf of ABA, Before the House Subcommittee on Financial Institutions Supervision, Regulation and Insurance, Committee on Banking, Finance and Urban Affairs, 99th Cong., 1st Sess. (Oct. 9 and 10, 1985) at 33-34.

[3]Statement of Preston Martin, Former Vice Chairman of the Federal Reserve Board, Hearings on the Expedited Funds Availability Act before the Subcommittee on Banking, Finance and Urban Affairs, 98th Cong., 2d. Sess., April 4, 1884, at 193.

[4]See, Statement of CFA, CU, and Congress Watch, Hearings before the Senate Committee on Banking, Housing and Urban Affairs, 100th Cong., 1st Sess., January 23, 1987.

[5]See, Testimony of Ellem Broadman, Consumers Union, before the Subcommittee on Consumer Affairs, Senate Committee on Banking, Housing and Urban Affairs, 98th Cong., 1st Sess. (Sept. 28, 1983) at 125.n.5.

In addition to this fee income, long holds also generate interest income for banks. While consumers are forced to wait to access their own money, banks are able to invest the funds for their own benefit. In 1985, the House Banking Committee estimated that banks generate $290 million annually in "float" income.[6]

Thus, the 1987 Act was an important victory for consumers. Recognizing that voluntary efforts to reduce abusive hold periods had failed, it established a September 1990 deadline for all banks to comply with a reasonable and fair maximum hold period schedule. This important consumer victory should not be undermined just as this long-awaited deadline approaches.

THE AMENDMENTS[7]

I. TO ALLOW BANKS TO INVOKE ADDITIONAL EXCEPTIONS TO THE NEXT DAY AVAILABILITY SCHEDULE

We oppose this amendment, which would expand the Act's current list of "exceptional" circumstances under which banks can place lengthy holds on checks that are otherwise eligible for "next day" availability. Instead, we support an amendment to eliminate all but two of the exceptions to the "next day" schedule that are presently allowed under the Act.

Under section 603(a) of the Act certain checks are given next day availability in certain circumstances because they present very low risk. These checks include:

-- cash
-- Treasury checks endorsed by the payee
-- checks drawn on state and local governments as long as they are endorsed by the payee and deposited with a special deposit slip
-- cashier, certified and teller checks
-- checks drawn on an account at a branch of the receiving institution (i.e., on-us checks)

Section 604 of the Act also prescribes certain circumstances under which the next day hold period and the hold periods that apply to other categories of checks may be ignored, in which case the bank may generally impose any hold period that is reasonable.

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[6]H. Rpt. 99-404 on the Expedited Funds Availability Act at 12.

[7]Our testimony discusses 4 of the 6 amendments that have been proposed. We do not have sufficient information to comment on the other 2 amendments at this time.

Some, but not all, of these exceptions apply to "next day" checks.

The amendment proposed by the industry and the Federal Reserve Board (FRB) would extend all of the exceptions, rather than the limited ones that currently apply, to "next day" checks, allowing banks to place lengthy holds on them.

We oppose this amendment because, except in the case of certified or cashier's checks, this special class of "next day" checks does not present the sort of risk that long hold periods can prevent. Long holds are generally designed to protect banks from losses that do not involve forgeries or similar forms of fraud. Except in the case of certified or cashier's checks, delayed availability policies simply cannot protect against these types of risks because institutions do not have the time or the expertise to uncover forged signatures or counterfeited checks within the short time available under the Uniform Commercial Code (UCC) to decide whether the check should be honored. Similarly, the holder of an account against which a forged check is drawn will not learn of the forgery until he receives the account statement.

Thus, the exceptions should only apply to those checks that may be returned because of a lack of funds in the account on which they are drawn. Government checks, certified checks, and cashiers checks do not present this risk. "On-us" checks could present this risk, but long hold periods are not necessary to protect against this risk because the institution on which the check is drawn is the same institution into which the check is deposited. The institution can promptly "tell itself" whether there are sufficient funds in the account to cover the check.

Of course, cashier, certified and similar checks could be counterfeited. Provided the institution on which they are purportedly drawn keeps efficient records, that institution could detect the counterfeit within the time allowed under the UCC to return the check to the bank in which it was deposited. Thus, a lengthy hold could be useful to allow this scenario to unfold.

However, a lengthy hold is totally unfair to consumers in the case of cashier's, certified and similar checks. Consumers pay for these special categories of checks with the understanding that they are better than a personal check, indeed, that they are as good as cash. If the banking industry wants to treat them like a personal check by placing long holds on them, then they should discontinue offering them. If they want to continue offering them, then they should make them "counterfeit proof."

Although we believe these checks should be subject to the same availability schedule as cash, the Act already allows the industry to subject them to more restricted availability. We believe these restrictions should be eliminated rather than expanded as the

industry would like.

For example, when a consumer opens a new account using a certified check, he expects that the cost of obtaining a certified check will give him the advantage of very prompt access to his funds. However, under section 604(a)(3) of the Act only the first $5,000 is available on the day after the certified or similar check is deposited. The consumer will have to wait up to 8 days after deposit to get access to the balance of his funds.

Similarly, under section 604(c)(1) of the Act certified and similar checks are already subject to the "reasonable cause" exception. Since the bank on which the check is drawn has already certified that there are sufficient funds in the account to cover the check, this exception is also unnecessary. We believe that the Act should be amended to eliminate this unwarranted application of the "reasonable cause" exception to this class of checks.

The only exceptions that should apply in the case of "next day" checks are the "fraud loss" and "emergency" exceptions. Under the first exception, institutions may impose a lengthy hold (i.e., a reasonable one under the circumstances) on any class of checks if the FRB determines that that class of checks is producing "an unacceptable level of losses due to check-related fraud" and the fraud can be reduced by suspending the hold periods that would otherwise apply. Section 604(e). Under the second exception, banks may impose a lengthy hold if there is an emergency, such as an interruption of communication facilities. Section 604(d). The Act applies these exceptions, in addition to the ones already described, to all "next day" checks. No additional exceptions are necessary or justified.

II. LIMIT THE NEXT-DAY REQUIREMENT FOR TREASURY CHECKS AND "ON US" CHECKS TO CHECKS DEPOSITED AT STAFFED TELLER FACILITIES

Here, too, we believe the Act should be strengthened to better protect consumers, rather than weakened to allow banks to impose longer holds in unwarranted circumstances.

Section 603(a) of the Act states that certain deposits must be given next day availability if they are deposited "in a receiving depository institution . . . staffed by individuals employed by such institution." Treasury checks and "on-us" checks receive next-day availability under this section regardless of where they are deposited. On the other hand, section 603(e)(2) of the Act allows banks to impose a 1-day hold on these same checks if they are deposited into a non-proprietary ATM. Read together, these two sections indicate that all next day checks must receive next day availability if they are deposited into a brick and mortar facility or a proprietary ATM.

However, the Federal Reserve, in its implementing regulations,

subjects all "next day" checks except Treasury checks and on-us checks to a 1-day, rather than next day, hold period if they are deposited into a proprietary ATM.[8] Along with the industry, it seeks to expand this already unwarranted 1-day hold period to Treasury and on-us checks deposited into proprietary ATMs.

We believe the FRB's treatment of "next day" checks deposited into proprietary ATMs is invalid as a matter of statutory construction. Since the Act only expressly allows an extra day's hold period in the case of "next day" checks deposited into non-proprietary ATMs, it clearly implies that "next day" checks deposited into proprietary ATMs should not get this special treatment.

We also believe its regulatory scheme and its proposal to make Treasury checks and on-us checks conform with this scheme is invalid as a matter of practical necessity. Checks deposited into proprietary ATMs can be immediately processed by the owner of the ATM just as if they were deposited at a live teller window.

III. WEAKEN THE NOTICE REQUIREMENTS

The 1987 Act attempts to remedy the serious problems consumers face when they are unaware that a hold, or a hold exceeding the normal time period, has been placed on a deposit. As we discussed earlier, consumers can face serious embarrassment, inconvenience, and cost when this occurs. Thus, when a bank places an unusually long hold under the exception provisions of the 1987 Act, the Act requires it to notify the consumer 1) when the funds will be available and 2) why the exception has been invoked. Generally, this notice must be provided when the deposit is made or "as soon as practicable" after the bank first knows the facts giving rise to the exception.

The FRB has proposed amending this notice provision in two cases: where an exception is invoked because 1) the aggregate deposit amount exceeds $5,000 and 2) the account of the consumer has experienced repeated overdrafts. Although it is vague in describing exactly how the notice provisions should be changed, it generally appears to support a one-time notice that would be provided the first time either of the two exceptions applies to the account. It argues that this change would benefit banks by reducing their costs and also benefit consumers if the Board were given the flexibility to require banks to include in this one-time notice information in addition to that required under the Act.

First, the Board's proposal, as we understand it, would not give consumers the most important information now required under the Act. A one-time notice cannot tell consumers on a case-by-case

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[8] 12 C.F.R. 229.10(c)

basis exactly when the funds deposited will be available for withdrawal. The one-time notice can only state the policies that will apply in the future, leaving it up to the consumer to figure out how the policy will apply in the case of a particular deposit. This will require the consumer to remember the exception policy, or to retain the one-time notice indefinitely into the future -- an uncertain proposition at best. Even if this occurs, the complexity of the exception rules could make it difficult for the consumer to apply them in the case of a particular deposit.

Second, it is extremely questionable that the Board's proposal will reduce costs to the industry. The present notice requirement cannot be significantly costly since tellers can provide the notice at the time the deposit is made under both exceptions, particularly in the case of the "large dollar amount" exception. On the other hands, banks will incur significant costs under the Board's proposal since they will have to keep track of the customers to whom they have provided the one-time notice.

Third, the Board's suggestion that an amendment would actually benefit consumers by giving the agency flexibility to provide additional information to the consumer is a red herring. If the Board believes that consumers need more information beyond that already required under the Act, it can use its general rule-making authority to simply require banks to provide that information. No amendment is needed for the Board to improve the regulations to benefit the consumer.

IV. MODIFY THE SCHEDULE FOR ALL DEPOSITS MADE AT NON-PROPRIETARY ATMS BY SUBJECTING THEM TO THE LONGEST HOLD PERIOD ALLOWABLE FOR NON-LOCAL CHECKS

This amendment, which would subject all deposits into non-proprietary ATMs to a 4-day hold period, is particularly onerous. Under the Act's permanent availability schedule, which becomes effective this September, a "local" check deposited into a non-proprietary ATM would be available on Wednesday. Under the amendment, the same check would not be available until the following Monday. This is a significant extension of the time consumers must wait to get access to their own funds, and one that is totally unwarranted.

The number of checks deposited into shared ATMs is significant. The Federal Reserve Board itself reports that one ATM network receives approximately 1 million deposits each month at nonproprietary ATMs.[9]

There are many reasons consumers use ATMs to deposit checks

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[9]Board of Governors of the Federal Reserve System Deposits at Nonproprietary ATMs (Oct. 1989) at 3.

and other items. First, many consumers are forced to use ATMs because bankers still keep bankers' hours. Many consumers simply cannot get to the bank within its normal business hours. Second, some banks require consumers to use ATMs to qualify for lower cost banking services. For example, one of the least expensive accounts offered by a major bank in California (relative to its other accounts) requires the accountholder to make deposits into an ATM.[10] If all transactions are conducted via the ATM, the monthly maintenance fee is $3.50. If the consumer needs to make a deposit or withdraw through a live teller, the consumer is socked with an additional $5.00 service charge. Consumers already have to brave inclement weather and security risks when they use an ATM, often under forced circumstances. They should not also have to suffer the significant delays in getting access to their own money that this amendment would require.

Aside from the serious detriment to consumers that this amendment would produce, the amendment is unnecessary. First, the Federal Reserve itself reports that most ATM networks make deposited funds available on an immediate or next day basis without suffering significant losses from returned checks.[11] If this practice works for the majority of institutions, it should work for all institutions.

Second, the burden of showing that this amendment is necessary even from an operational standpoint is on its proponents, and they have not come close to meeting this burden. They argue that, under current operating procedures, ATM network operators do not process the checks deposited into the ATM to determine the hold period that should apply. Although systems are in place to relay some information about the deposit to the accountholding institution, they do not relay hold period information since they simply do not obtain it. Consequently, they argue, deposits into non-proprietary ATMs should be exempt from the hold schedule that applies to deposits into proprietary ATMs and live tellers simply because ATM operators would have to change their operating procedures to give consumers the protections they deserve.

Congress was aware when it passed the 1987 Act that ATM network operators would have to change their operating procedures if participating banks wanted to be able to impose the longest hold allowable for each category of check under the 1990 schedule. It generously gave the industry 3 years to change their procedures to meet this minimal compliance goal.

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[10]CALPIRG, Consumer Guide: A Survey of Deposit Accounts and Credit Card Services of Banks and Savings and Loans Assoc. in the Greater Los Angeles Area (July, 1989) at 10.

[11]Note 9, supra at 13.

First, for the most part the operational systems that shared ATM operators need to meet the permanent availability schedule are the same that banks need for processing deposits obtained over the counter or through proprietary ATMs. They would simply need to put the checks through a sorter process, a step that is already required to route the check to the institution on which it is drawn. To the extent this sorting process is more difficult for "holds" purposes than routing purposes, these difficulties are no greater simply because a check is deposited into a shared ATM.

The Act recognizes that deposits into shared ATMs may be deposited into accounts held by institutions in various locations, including institutions outside the ATM's own check processing region. It would be a difficult task, indeed, if the ATM operator had to distinguish between local and non-local checks on the basis of the location of the accountholding institution relative to the location of the institution on which the check is drawn. Recognizing this difficulty, the Act allows ATM operators to treat all checks alike for this purpose. Section 603(e)(2)(c) of the Act specifies that a check deposited into a non-proprietary ATM is "local" for hold period purposes if it is drawn on an institution in the same check processing region as the ATM, rather than an institution within the same check processing region as the institution into which the check is deposited.

In other words, this section eases the administrative burden that would otherwise apply to shared ATM deposits by allowing the ATM operator to treat all deposits as if they were deposited into its own customers' accounts. In turn, the Act expects the bank that owns the ATM to process the checks to determine hold periods just as it must process checks received at brick and mortar facilities. On the other hand, this amendment would allow non-proprietary ATM operators to avoid the processing operations that all banks have to perform in the case of checks deposited at brick and mortar facilities.

The only distinct operational requirement that the Act imposes on non-proprietary ATM operators is transmitting the hold period information it obtains to the accountholding institution. Of course, some information regarding the nature of ATM deposits is already transmitted electronically to accountholding institutions, including the date of the deposit and the dollar amount of the deposit. The Act only requires the minority of networks that do not already provide prompt availability to include hold period information in this electronic transmission.

The Federal Reserve Board summarily reports that these operational modifications would "substantially increase the cost

of processing deposits made at nonproprietary ATMs."[12] This totally undocumented statement is simply insufficient to reverse the consumer protections Congress passed in 1987.

Part, if not most, of the costs of identifying the maximum hold periods on shared ATM deposits are already incurred when the ATM operator sorts the checks for routing purposes. To the extent additional sorting is required to determine hold periods, the costs associated with this sorting process are not peculiar to ATM operators, but are required of all banks. Finally, we would be very surprised to learn that the one-time cost associated with the only required operational change that is peculiar to shared ATM deposits, i.e., the cost of modifying software so that hold period information can be transmitted from the ATM operator to the accountholding institution, is substantial.

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[12]Note 9 supra at 10-11.

Senator DIXON. Thank you.
Mr. Mierzwinski.

STATEMENT OF EDMUND MIERZWINSKI, CONSUMER LOBBYIST, U.S. PUBLIC INTEREST RESEARCH GROUP

Mr. MIERZWINSKI. We are pleased to come and testify before you. Many of the PIRG's worked on State check-hold acts before the passage of the Federal law. We published a number of reports which we hope were helpful to you and your colleagues, especially Senator Dodd, the sponsor of the bill, in passage of this act, which we think has been very successful.

For example, we published the report, "Held up at the bank" in 1985 and the report "Still held up at the bank" in 1986. These reports found that banks held local checks for periods of up to 7 to 9 days, and nonlocal checks for periods of up to 14 days.

"Still held up at the bank," for example, found that 53 percent of 458 banks in 11 States held local checks for 3 to 5 days. Fourteen percent for over a week. And 76 percent held the nonlocal checks over a week. And 20 percent held nonlocal checks over 2 weeks.

The study found wide disparities. Forty-one percent of Oregon banks were found to hold nonlocal checks over 2 weeks.

We believe, first, the passage of the State acts and then passage of the comprehensive Federal act have made a great difference to consumers in their ability to obtain the use of funds that they deposit into their accounts.

I conducted over the last week or so, since being invited to testify before you, an informal survey of a number of the individuals who helped to publish some of the PIRG reports and worked on the State PIRG's and other organizations around the country. Uniformly, they support the act and find that the consumers that we speak with are very pleased with the act.

Our field outreach staff talks about PIRG's to over a million consumers and families per year. We ask consumers what they think about the act. We don't ask every consumer that, but we ask a great deal of them what they think about the act. And consumers are uniformly supportive of the results of the Expedited Funds Availability Act.

They also are very aware of the issue. The disclosure requirements required by the law have benefited consumers. They now understand what the policies are if a policy exists that might be to hold a check for a longer period than what the schedules allow.

In addition, the Federal Reserve Board is required to report to Congress on how well the act is working for both the industry and consumers. In their June 1989 report, they suggested that the act, quote: ". . . has an impact on consumers that is positive."

We support that, and we believe that our data comport with that.

I would clarify something on page two where I say that we believe that 80 percent of institutions have shortened their hold periods. I had extrapolated that number from the 1989 report of the Fed. After going over it again, I realized that it is 80 percent that had either shorter hold periods or at least the same hold period.

There is no, in my view, ability from the data in the report to extrapolate whether or not more institutions have lengthened their period or not.

That 80 percent at least, since passage of the act, have either a shorter period or a period that was the same as before the act we think that is beneficial to consumers.

I would agree with the testimony of Consumers Union and U.S. PIRG would oppose each of the amendments offered by the industry and the agency here today.

First, there is one amendment on the operational and disclosure difficulties concerning the payable check ruling. On that amendment, we do not have a position. But, on the other five, I will briefly give you our position.

Expand the applicability of the exception holds to the availability schedules to checks that must be given next day availability.

Essentially, we don't believe that extending the exception holds will protect the banks from any losses, and we would oppose the amendment. There are a number of arguments that can be made, in fact, that cashiers and similar checks should always have the same availability as cash, although the act provides for in certain circumstances that they do not.

Proposal three is to limit the next day requirement for Treasury checks to checks deposited at staff teller facilities and "on-us" deposits.

And, again, we believe that the act requires that for proprietary ATM's, that those be given the same availability, although the Fed has interpreted it differently.

Proposal number four is to provide greater flexibility in the manner of giving notice to the depositor that an exception has been invoked. The arguments in favor of this make a number of points.

We believe, again, that for these types of notices, most of them would not incur larger mailing costs first because they would be provided by the teller.

And, second, we believe that the current law provides greater information to the consumer.

I don't know how a general notice provided at the beginning of an extended hold period could possibly tell the consumer what the current law notice requires. For example, when his or her deposit will actually be available.

We don't oppose institutions providing such a notice in advance. In fact, we believe that the Fed could require institutions to provide an additional notice to those required in the act. But we don't think that should be the only notice.

Concerning the nonproprietary ATM deposits, the proposal would have them treated in the same manner as they are under the temporary schedule when they are under the permanent schedule.

One of the major problems we have with this is the fact that, for a number of consumers, ATM's may be the only bank that they have an opportunity to go to. As banks convert branches into ATM's and consumers have less choice of going to branches, as branches are not open as open as often as they used to be, at least in certain possibly low-income neighborhoods, consumers have no choice but to go to an ATM.

So, in addition to the fact that we don't believe that the industry has met a burden of proof, that the changes cannot be implemented to the ways in which they are transmitted from these nonproprietary ATM's.

We would argue that it is very important that the committee consider the needs of consumers who may have no other choice other than to use these ATM's.

There was an article in the Business Week this week, and I'm sorry I didn't bring it with me, but some sort of bank executive was given an award for converting 320 banks into ATM's. So it is very clear that there is a trend in the industry that machines are going to be the way we do our banking.

We would hope that we can get prompt availability from the machines.

Mr. Chairman, on the final amendment, I recently received information that I would need to comment on this, and we will comment on the final amendment in writing before you close the hearing record.

I would also just briefly point out that we would encourage the committee to wait on these amendments until the permanent schedule is invoked, so that we have a chance to look and see whether there are any problems.

We can always look at this next year.

I would then encourage the committee to work on instead access to financial services legislation, which is also before the committee, which of course our group also supports.

Thank you.

[The complete prepared statement of Edmund Mierzwinski follows:]

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Testimony of the

U.S. Public Interest Research Group

Before The

Senate Banking Committee

Consumer and Regulatory Affairs Subcommittee

1 March 1990

Concerning The Expedited Funds Availability Act

Edmund Mierzwinski
Consumer Lobbyist

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TESTIMONY OF THE U.S. PUBLIC INTEREST RESEARCH GROUP (U.S. PIRG) CONCERNING THE EXPEDITED FUNDS AVAILABILITY ACT

Senator Dixon and distinguished committee members: U.S. PIRG is pleased to offer our views on proposed amendments to the Expedited Funds Availability Act,[1] which limits the amount of time banks[2] can "hold" checks deposited to an account.

As you know, U.S. PIRG serves as the National Association of State PIRGs. The PIRGs are independent, non-profit, non-partisan consumer and environmental research and advocacy groups.

From the outset, we would summarize by suggesting that these amendments are not ripe. The Act's primary protection for consumers goes into effect 1 September 1990. The committee should evaluate the Act after that time, when it has been fully implemented. In the interim, we strongly urge attention to the important basic banking and check cashing issues before the committee, before considering prospective amendments to this Act.

Background and History

Prior to passage of the Act, several of the state PIRGs, including New York and Massachusetts, had successfully advocated the passage of state "Checkhold Acts." The PIRGs also conducted two national studies documenting the need for federal legislation. **Held Up At The Bank (1985)** and **Still Held Up At The Bank (1986)**[3] found that banks held local checks for periods of up to 7-9 days and non-local checks for periods of up to 14 days. **Still Held Up At The Bank**, for example, found that 53% of 458 banks in 11 states held local checks for 3-5 days, 14% for over a week; that 76% held nonlocal checks over a week, and 20% held nonlocal checks over two weeks. The study found wide disparities, with 41% of Oregon banks, for example, holding nonlocal checks over two weeks.

We would like to again commend the committee, especially the Act's principal sponsor, Senator Dodd, for your commitment to passage of this comprehensive Act which has given consumers more rapid access to deposits and prohibited unfair holds.

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[1]The Expedited Funds Availability Act is Title 6 of the Competitive Equality Banking Act, Public L. 100-86, (August 10, 1987) (12 USC 4001 et seq.). The Federal Reserve Regulation implementing the Act is Regulation CC 12 CFR 229, effective September 1, 1988.

[2] Reg. CC uses the term "bank" for convenience to describe banks, savings and loans, credit unions, and other depository institutions covered by the Act, which uses the term "depository institutions." For convenience, we use the term bank.

[3]These reports, coordinated by U.S. PIRG and conducted by the state PIRGs around the country, surveyed 669 and 458 banks, respectively.

We have been asked to comment on the Act and how well it has served consumers. We have also been asked to comment on the need for revision to the Act, and specifically on amendments which have been proposed by the Federal Reserve Board and the industry.

We hope you find the following comments useful in your deliberations.

How Well Does U.S. PIRG Find The Act Is Working?
How Well Has The Statute Served Consumers?

U.S. PIRG recently conducted an informal survey of staff in the state PIRGs and other consumer organizations and found uniform strong support for the Act. Our advocacy and education staff find the Act has both shortened checkholds and also increased consumer awareness of the issue. Our field outreach staff, who talk to over a million families a year about our work, find that consumers know about the Act and are very pleased it passed. Consumer groups say questions and complaints about check hold policies "have virtually disappeared" since passage of state and federal checkhold laws.[4]

As you know, under section 609(d)1(B)ii, the Federal Reserve Board is required to regularly report to Congress on the "impact of this title on consumers and depository institutions." Our review of the June 1989 report suggest that the board's studies correlate with our own: "Overall, the impact of the Act on consumers appears to have been positive."[5]

The Board's 1989 report surveys bankers on checkholds before and after the law. Overall, of 66% of respondents with an explicit hold policy before the Act, 87% report a net improvement after the Act. Of 34% without an explicit policy before, 65% estimate an improvement.[6] Extrapolating from these data, at least 80% of institutions have shorter hold policies than before the Act. It should also be noted that passage of state checkhold laws served as a strong impetus for the federal Act for several reasons. Both consumers and the industry wanted assurances that checks sent interstate would clear rapidly and uniformly. Also, consumer groups wanted obstinate federally-chartered institutions to comply with their state Acts.

The Massachusetts study, although it compares compliance

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[4] Personal Communications, February 1990: Ken McEldowney, Director, San Francisco Consumer Action; Jon Steubenvoll, Director of Consumer Affairs, Oregon State PIRG; Josh Kratka, MassPIRG Consumer Lobbyist and author: "Sinking The Bank Float: The Success of the Massachusetts Check Clearing Law," MassPIRG, August 1986; Blair Horner, Legislative Director, New York PIRG, and others involved in passage of state laws and the federal Act.

[5] **The 1989 Report To Congress Under The Expedited Funds Availability Act,** Federal Reserve Board, June 1989, page 20.

[6] Ibid., page 17, Table 1.3 and text.

before and after a state law passed, found similar results, although its data are not directly comparable because researchers indicate that nearly all banks not in compliance after the Act were federally-chartered institutions.[7]

The Consumers League of New Jersey, in an informal 1989 study[8] compared compliance today with the 15% compliance in 1986 found by a New Jersey PIRG checkhold study.[9] While the Consumers League sample was much smaller, it found all institutions in compliance with several institutions already **exceeding** permanent schedule requirements.

We believe the data uniformly indicate that the Expedited Funds Availability Act has been a rousing success.

Based on practical experience since its enactment, are any revisions needed to this statute or its accompanying regulations? What is your view of the amendments proposed by the Federal Reserve Board or the banking industry?

First, we would state that, in our view, the statute generally needs no amendments, particularly those which would increase hold times. As you know, this committee and its counterpart on the other body worked long and hard to ensure that the reasonable concerns of the industry would be dealt with. The result is a long and detailed statute and accompanying regulation.

The guiding principles of the Act's drafters were the following:

1) to shorten hold times to the extent feasible (with a longer temporary schedule to ease implementation);
2) to allow reasonable exceptions where banks might be at risk of loss due to higher uncollectible or fraud which could be attributed to the Act;

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[7] See footnote #4 for citation. The Massachusetts law is Chapter 390 of the Acts of 1984, 209 CMR 37.00. The law is generally preempted by federal law, but like other state checkhold acts, served as a model for federal legislation. The Massachusetts law is comparable to the permanent schedule of the act, with the Act's permanent schedule in *italics* and Massachusetts law in parentheses: on us checks, *next day* (2 days); local checks, *2 days* (3 days, includes all New England states as local); nonlocal checks *5 days* (same outside New England). Exceptions to the schedule: *new accounts* (same); amounts greater than *$5000* ($2500); both laws have very similar exceptions for repeated overdraft accounts and good faith or reasonable cause.

[8] New Jersey Consumers League, "Checkhold Study," sent to Federal Reserve Board Consumer Advisory Council Secretary Ann Marie Bray 15 February 89.

[9] "Held Up At The Bank," 1986 New Jersey PIRG study, cited in 1989 Consumers League of New Jersey report to Federal Reserve Board, see previous footnote.

3) to avoid increasing costs, to the extent feasible.

We believe the Act's implementation under the current temporary schedule has demonstrated the wisdom of its drafters. While the Act has required consumer and industry education, has been technology-forcing and also required the use of improved return procedures, we believe overall it has been extremely successful.

Further, we see no evidence in the board's reports of a pattern of increased fraud or uncollectible due to the Act.

Also, we remain unconvinced that there is a direct relationship between longer hold times and fraud, especially in the circumstance where the proposed amendments would increase hold times and exceptions to the permanent schedule for items such as cashier's and treasury checks. For those items, we do not believe increased hold times or exceptions will make a difference.

As requested, here are comments on amendments proposed in the 1989 **Report To Congress Under The Expedited Funds Availability Act** and the Board's report on deposits to non-proprietary ATMs.[10] We would respectfully point out that our comments are based on short descriptions of proposed amendments found in these reports.

Also, we incorporate herein by reference arguments made in the testimony today of Consumers Union.

Proposal #1:[11] *Resolve the operational and disclosure difficulties that the payable through check ruling has caused.*

The Board has amended Regulation CC to comply with a 1988 court ruling that the determination of whether a credit union payable through draft is local or nonlocal should be based on the location of the credit union rather the location of the payable through bank.

It has not been suggested to U.S. PIRG that this amendment is on the table at this time so we will not comment.

Proposal 2: Expand the applicability of the exception holds to the availability schedules to checks that must be given next day availability.

This amendment would expand the exceptions to the availability schedules to include coverage of next day checks as well as local and non-local checks.

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[10] **Deposits At Nonproprietary Automated Teller Machines,** Federal Reserve Board Report To Congress, October 1989.

[11] The first five proposals are from the Board's **1989 Report To Congress Under The Expedited Funds Availability Act**. See pages 21-22 of the report.

Again, there is a presumption that an exception hold would solve a prospective problem, as yet undefined and undocumented, of either insufficient funds or forgeries of checks granted next day availability.

Basically, we oppose this amendment as superfluous. It is not on point to argue that longer hold periods will protect banks from losses for next day checks subject to forgery or insufficient funds. Further, the bank always checks, or has the ability to check, on-us checks for sufficient funds.

Second, extension of the hold on cashier, certified, and similar checks nullifies the value of the consumer's purchase of a check he or she thought would be as good as cash.

The intent of this amendment, we presume, is to reduce the chance of forgery of these checks. We believe the small chance of this, weighed against the consumer's extra expense in purchasing one of these checks, fails to justify an extension of the Act's exception conditions. In fact, an argument can be made that cashier's and similar checks should have the same availability as cash.

Proposal #3: Limit the next-day requirement for Treasury checks and "on-us" checks to checks deposited at staffed teller facilities.

As above, the primary argument for reducing the availability of these Treasury and on-us checks is weaker than the argument for keeping things the way they are or even strengthening the Act.

First, we would point out that the Federal Reserve Board has resolved an ambiguity in the law in favor of longer holds, already, although its authority to do so is questionable. By extension, it seeks to apply its previous action to Treasury checks and on-us checks, which were clearly granted next-day availability.

However, since the Act explicitly allows an extra day's hold for next day checks deposited into non-proprietary ATMs, it implies that next day checks deposited into proprietary ATMs would not be subject to the additional hold.

We would urge reversal of the board's previous interpretation and make all next day check deposits into proprietary ATMs available as if they were deposited in what the commentary calls teller windows in "brick and mortar" facilities.

Proposals #4: Provide greater flexibility in the manner of giving notice to the depositor that an exception has been invoked.

The board proposes tailoring the exception notices required by the Act, arguing that for certain of the exceptions, the notice requirement is both costly and not useful to the customer. The board's arguments, as with each of the other amendments proposed, are sparse; we cannot find any justification for the change.

Section 604 of the Act[12] provides for "safeguard exceptions" to both the temporary and permanent availability schedules. Except for Section 604(a) new account exceptions, the Act requires a notice when an exception is invoked. These include the following Section 604(b-e) check exceptions:

--(b)(1) large deposits exceeding $5000 in one day;[13]
--(b)(2) returned and redeposited checks;
--(b)(3) repeatedly overdrawn accounts;[14]
--604 (c) exceptions requiring notice are for reasonable cause to doubt collectibility;
--604 (d) emergency conditions beyond the bank's control, including interruption of computer and communication systems;
--604 (e) prevention of fraud losses.

Section 604(f) requires an exception notice to be given at the time a deposit is made in person (interpreted by Regulation CC to mean to a staffperson of the receiving bank). If a deposit is made by ATM or other means, or if the bank reasonably determines an exception hold is necessary after the time of a deposit, the notice must be mailed or delivered by the next business day after deposit. If a deposit is held subject to 604 (d) emergency conditions, the notice is subject to regulations of the Board, under Regulation CC, 229.13 (g)(2)(ii) the notice is not required if the hold is removed before the notice would otherwise be required to be sent (the next business day) then no notice is required. The board's commentary illustrates:

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[12] Section 229.13 of Regulation CC.

[13] By Regulation CC Section 229.13 (c) the Board clarifies the Act's $5,000 amount to include all an aggregate of all amounts deposited to all accounts held by the customer, "even if the customer is not the sole holder of the accounts and not all of the holders of the accounts are the same."

[14] Defined by Regulation CC Section 229.13 (d): Repeatedly overdrawn accounts are those which have negative balances on six or more banking days in the previous six months (or the account would have been negative if checks or other charges to the account had been paid **OR** if on two or more banking days within the previous six months, the account balance is negative or would become negative if checks and other charges are paid, in an amount greater than $5000.

> For example, if on the last day of a hold period the depositary bank experiences a computer failure and customer accounts cannot be updated in a timely fashion to reflect the funds as available balances, notices are not required if the funds are made available before the notices must be sent.[15]

The Board believes that the Act may be appropriate for reasonable cause and returned check exceptions, but not for the large deposit and repeated overdraft exceptions. It feels that repeated notices would be expensive.

How expensive? How excessive? No data have been provided.

The Board's reasoning is twofold: lower cost to the bank and greater utility to the customer. However, the board's arguments are not supported by any data.

First, if the objection is mailing costs, for the large deposit exception, any teller can easily provide a notice when a deposit is over $5000. No mailing is necessary. In most cases, the aggregate $5000 limit to multiple accounts (see footnote 13) would not apply.

And for repeated overdraft accounts, each account in this category could be flagged so that tellers accepting deposits would automatically note the account's condition. Again, no mailing is necessary.

Second, the Act's notice requirement provides that exception notices describe the day funds will be made available. Section 604 (f) states the following:

> (1) If any exception contained in this section (other than subsection (a)[new accounts]) applies with respect to funds deposited in a an account at a depository institution--
> (A) the depository institution shall provide notice in the matter provided in paragraph (2) of--
> (i) the day the funds shall be made available for withdrawal; and...

How would a one-time notice apply this section? The Board's proposal wouldn't provide the same benefits and information as currently provided in the Act.

If the Congress wishes to expand the flexibility available to institutions, we believe the Board should develop additional substantiation of the problem and additional explanation of the implementation. We believe at this time that a reduction in

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[15] Regulation CC Commentary To Paragraph 229.13, p. 39.

notice requirement will be detrimental to the consumer.[16]

Proposal #5: Explicitly subject state and local governments on which checks are drawn to liability rules for violations of the Board's check collection and return requirements.

We understand that this proposal would apply to a small number of states which issue "warrants" drawn directly on the state (or other political subdivision). We have requested that Board staff provide us with additional information on the extent of this practice.

Proposal #6:[17] Treat nonproprietary ATM deposits under the permanent schedule in the same manner as they are treated under the temporary schedule.

This amendment has been presented as a response to the industry's failure to gear up systems to rapidly ascertain the content of non-proprietary ATM deposits.

First, we are very concerned from a non-technical standpoint. We have seen data that indicate the industry is closing branches and replacing them with ATM machines. As this occurs, consumers will have fewer "staffed" banks to make deposits at. As it is, lower-income communities increasingly find their branches only open 9-3, Monday through Friday.

If this amendment passes, we are concerned that many consumers who have no choice but to deposit at non-proprietary ATMs will face long holds.

We would encourage the committee to seek alternative solutions to this perceived problem. Also, if you go ahead with this amendment, we would strongly recommend a two-year sunset, that is a continuation of the original technology-forcing goal, to avoid disenfranchisement of individuals who have no choice. We would suggest an automatic sunset, reverting to current law, unless Congress acts affirmatively to again extend the temporary schedule.

Second, from a technical standpoint, the case has not been made by industry that this amendment is necessary to resolve an operational problem. The board's statement that banks make ATM deposits promptly available, "and generally did not place holds

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[16] An uncredited fact sheet, apparently produced by the industry, distributed to us by various Congressional staff, would allow the single notice also in the case of the **redeposited checks exception,** in addition to the **repeated overdrafts** and **large deposits** exceptions. We also oppose this proposal, which comes with even less justification, since the board report explicitly states it is not necessary.

[17] See the Federal Reserve Report To Congress: **Deposits at Nonproprietary Automated Teller Machines** October 1989 for a discussion of this amendment, page 17.

on either proprietary or nonproprietary ATM deposits[18]" hardly makes a case for this amendment. Further, the board's limited two-sentence discussion dumps all operations costs onto this portion of the Act, without justification.

A detailed analysis is made by Consumers Union. We associate ourselves with their testimony.

Conclusion

U.S. PIRG recommends that the committee take no action on these industry and agency proposals at this time. The proper time for consideration would be following implementation of the permanent schedule, if problems occur. We are also disappointed in the level of analysis provided to support these amendments.

In addition, we understand that the committee is considering attaching a package of these amendments to Senator Metzenbaum's Government Check Cashing bill that maintains its important goals

We would respectfully suggest to the committee that the need for Government Check Cashing and Basic Banking legislation is much greater than the need for these amendments. We would hope that consideration of these amendments will not delay the passage of the very important Government Check Cashing (S. 906) and Basic Banking (S. 907) bills before the committee.

Senator Dixon, we appreciate the opportunity to provide our views this afternoon. If you or any committee members or staff have any questions, please do not hesitate to call.

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[18] p. 13, **Deposits At Nonproprietary Automated Teller Machines,** October 1989, Federal Reserve Board.

Senator DIXON. Thank you, Mr. Mierzwinski.

Mr. Wittman, why would anybody buy a cashier's check, pay a fee to buy a cashier's check, if they could only get $5,000 the next day?

Mr. WITTMAN. The reason for proposing this amendment is because of the potential for fraudulent cashier's checks in the system. If a $20,000 cashier's check is deposited into a branch at 2 o'clock in the afternoon, under the availability schedule for a cashier's check, cash from the $20,000 check has to be payable to the customer at 9 o'clock the next morning. There is not enough time for the branch manager or the processing system to identify who issued that check—to determine if it is a valid check by the time the bank opens the following morning, because we've only got a 2-hour window from 3 o'clock to 5 o'clock to find out.

At 9 o'clock the next morning, the customer can come in and demand their cash.

Senator DIXON. You would ask that there be a $5,000 cap on what can be recovered on a second day? Is that right?

Mr. WITTMAN. That is correct. That would give us the additional time in order to determine the validity of the check.

Senator DIXON. You were talking about accounts repeatedly overdrawn. I did not quite get the point you were making there.

Would you give me that again? On accounts repeatedly overdrawn, a person who has an account repeatedly overdrawn, what is your position then?

Mr. WITTMAN. We would prefer to give the notice that the schedule of availability of checks into that account has been extended because the customer's behavior pattern has demonstrated that they do not properly manage the account.

So, rather than give the customer this notice every single time they make a deposit into their account, we would give it to them the first time they overdraw their account, tell them that: Because of your behavior on this account, you are repeatedly overdrawn.

Senator DIXON. You're not repeatedly overdrawn. You're overdrawn once, aren't you?

Mr. WITTMAN. If you overdraw once——

Senator DIXON. How many times is "repeatedly"?

Mr. WITTMAN. My personal feeling would be three times in a period of 2 or 3 months would be a pattern of being overdrawn. That would then require us to take a lot more diligent action on that particular account because the customer is not showing the bank the ability to properly manage it.

Senator DIXON. Is it your suggestion—I'm not being argumentative. I'm trying to understand this from the standpoint of what we ultimately do.

Is it your suggestion that we leave it to the financial institution to make that kind of subjective determination of what is a repeatedly overdrawn account?

Is that what you're saying?

Mr. WITTMAN. No. I think that can be built into the regulation as to what is a pattern of being overdrawn. That has been discussed in the past. I don't have the details, but I know that there has been discussion in the past about defining an account that is

considered to be repeatedly overdrawn. I would like to clarify this further and to send some additional information.

Senator DIXON. Your position is, if there is a regulation that defines what is a repeatedly overdrawn account, then, in that circumstance, you not being the one that makes that subjective determination, that you would have this opportunity to make that kind of a selective judgment in the institution.

Mr. WITTMAN. It would no longer be subjective, I don't believe.

Senator DIXON. I realize it would not be. Then you would be able to do that. Having found a situation that complies with the regulation? Is that your point?

Mr. WITTMAN. That is correct.

Senator DIXON. You also referred to new accounts, your point being: This is a new account and we don't know what it is like?

Mr. WITTMAN. Many banking losses are with new accounts where we have not had an opportunity to determine the banking practices of that individual to determine if they are going to properly manage the bank account.

Senator DIXON. Your position would be that you can do what with new accounts?

Mr. WITTMAN. If we have a longer period of time in which to understand how this customer is going to manage the account, we would be in a better position to safeguard our deposits because——

Senator DIXON. What are you suggesting the availability rule should be with respect to that kind of an account?

Mr. WITTMAN. I'm going to have to get back to you on that. I'm not clear right now as to what the availability is.

Senator DIXON. I would like on all of those, on the repeatedly overdrawn kind of account and the new account, to have your analysis of why that is a matter of great moment.

I mean, I can see how obviously an account that you've had a long time with John Doe, who never overdraws, is a considerably different circumstance. But I would like to have the analysis that what you suggest is the appropriate response.

Now you said something about credit unions that I simply didn't catch. What were you saying about credit union share drafts?

Mr WITTMAN. The ABA's position and the CBA's position support the Fed in terms of the amendments to the credit union share draft rule.

Senator DIXON. You take issue with Ms. Rectanus' position? She feels otherwise, I take it?

Mr. WITTMAN. Representing the ABA and CBA, yes, we do.

Senator DIXON. There's nothing like a good, healthy fight, I suppose.

Thank you very much, Mr. Wittman.

Now, Mr. Cole, if I understand the nature of your testimony with respect to the nonproprietary ATM's in which you suggest that there should be a modification, maybe you're even suggesting that the modification should make the permanent the same as a temporary? Is that what I think you suggested?

Mr. COLE. Yes, sir.

Senator DIXON. What you are arguing, in essence, is that the opportunity for fraud is so much greater in that situation than in a proprietary ATM.

Is that right?

Mr. COLE. That's right.

Senator DIXON. You cited certain cases. I presume you could make those cases, the specificity of it, known to us? I don't ask that it be done now openly before the crowd here, but the institutions who have had those experiences that you mentioned, the $13,000 deposit, took $3,000 one day, $2,500 the next—the account was no good.

Now, I don't mean to be argumentative when I say this, but I thought earlier you had suggested and maybe even Governor Angell had suggested that the technological information is not available for you to determine the status of the accounts. And then I thought later you said, yes, it is available. IBM does something like this, but it is a horrendous cost and these ATM's are $40,000 a piece, or whatever they are.

You are talking to a man who does not understand the cost factor here, I assure you, but I appreciate the fact that it is probably without question a substantial cost.

Now, what are you saying? Are you saying that technological information is not readily available at a decent price to build into the system in the nonproprietary ATM system?

Is that what you're saying to me?

Mr. COLE. I would not deny that there is technology, at least on the drawing board or in a test phase. But, for the financial institutions collectively to embrace that technology overnight just wouldn't be practical.

In the alternative, they would probably just choose not to accept deposits on a nonproprietary basis faced with the expense of totally replacing 75,000 machines, which, in essence, that would require.

Senator DIXON. Are you sure that would be the case? That if we do not take steps to accommodate what you suggest should be done, are you suggesting that institutions will not use nonproprietary ATM's?

Mr. COLE. I don't mean to sound like the baseball players and the baseball owners, but that is a possibility. I'm not going to predict that it may or may not happen, but it is a possibility.

I can speak for the Cash Station network in Chicago. It is probably likely that the institutions who sit on the board of directors and set the policy for the network would strongly recommend that effective September 1, that deposits cease to be an account function that can be—or a transaction—on a shared basis.

Senator DIXON. At the expense of being the devil's advocate here, obviously, of course, there is insurance that would protect you against these losses. I don't know what the bottom line is on an expense like that.

But, are you seriously suggesting to this committee that the cost of achieving the type of protection necessary to protect against the fraud you suggest is such that these institutions would abandon what is obviously a fairly attractive depository system for consumers?

Mr. COLE. I would suggest to you that that is, in fact, the case if you have an institution with 1,000 machines throughout a State, most of which are shared within an ATM network.

They would be faced most likely not with just retrofitting those machines, but in fact replacing them. One thousand machines times $40,000 per machine is a significant investment by a bank of any size.

Senator DIXON. You're not suggesting to the chair—maybe you are—that it could cost $40,000 for every one of those nonproprietary ATM's——

Mr. COLE. Yes, sir.

Senator DIXON [continuing]. To establish the kind of integrity in the system that protects it from fraud?

Mr. COLE. There are about six major manufacturers of ATM machines, including IBM, Diebold, Fujitsu. The only one that has a scanner available is IBM. Called the 4730, totally installed, it runs closer to $70,000.

They've only sold 100 of them throughout the entire country. The other five major manufacturers of these machines have not really developed this technology. While it may be on the drawing board, there's not another product available to the financial institutions.

So, not only would they be faced with replacing machines, but they would have a choice of one vendor only to make the acquisition from. There would be no competition.

Ms. MEIER. May I interrupt here?

Senator DIXON. You may. But I'm going to get you on the same subject anyway, Ms. Meier, so you will get your shot.

Ms. MEIER. OK.

Senator DIXON. OK.

Ms. MEIER. Sure.

Senator DIXON. I'm trying in the best way I can, as a person who does not have the necessary technological understanding, to make a finite judgment, to get enough in this record so that the people that I respect can make finite judgments.

You see what I'm trying to do.

Ms. MEIER. Sure.

Senator DIXON. It is important enough that I would appreciate your waiting for me to get back. I do have to go vote again. I'm sure it will be the last interruption we will have.

I want to clear up with Ms. Rectanus her fight with Mr. Wittman and then, I assure you, I will get to you, and Mr. Mierzwinski to better understand your dispute with Mr. Cole and see whether the arbiters here can ultimately make a judgment call on what I obviously see as a fairly good difference of opinion here.

That's why we are umpires, I guess.

If you all would excuse me, I'll try to get back in about 6 or 7 minutes. We will be in recess, if you don't mind.

[Recess.]

Senator DIXON. The meeting will come back to order. I thank you all for being so accommodating and waiting for me. I expect it is not necessary to tell Mr. Wittman that I have had my picture taken with Ms. Rectanus. If it bothers him any, he can have his picture taken with me, too. [Laughter.]

And the same for Ms. Meier in terms of my picture with Mr. Cole. Sort of like the story about the guy who sent the cigar to the judge. But, I won't bother you with that story. [Laughter.]

Now, Ms. Rectanus, would you enlighten the Chair about this whole business about your concern about the share draft system and the position taken that you take issue with so far as a change in regulations is concerned?

Ms. RECTANUS. Yes, Senator.

Currently, as a result of a district court ruling, payable through share draft is determined to be local or nonlocal based on where the credit union is located.

Senator DIXON. Where the credit union is located?

Ms. RECTANUS. Right.

Senator DIXON. That is a court decision and a lawsuit filed against whom?

Ms. RECTANUS. The Federal Reserve Board. It is local based on where the credit union is, not where the payable through bank is located, which most often is likely to be in a different Federal Reserve district.

Senator DIXON. I see.

Ms. RECTANUS. What the Federal Reserve Board is proposing is that local or nonlocal is determined based on where the payable through bank is located.

Senator DIXON. Was that the issue in the lawsuit?

Ms. RECTANUS. Yes, it was exactly the issue in the lawsuit.

Senator DIXON. Are you telling the chairman then that you won a lawsuit and the Fed wants to change the result of that lawsuit?

Ms. RECTANUS. Absolutely. That's exactly what happened.

Senator DIXON. That is not with any strings attached. It is just that simple?

Ms. RECTANUS. Yes, sir.

Senator DIXON. Ms. Meier, what do you think about Mr. Cole and his beef about all of this money?

Ms. MEIER. Well, a number of things.

Senator DIXON. I don't want you to tell the truth now if it's going to be that bad. [Laughter.]

Ms. MEIER. I just met him. [Laughter.]

First of all, I think you should know that the 1989 report submitted by the Fed on this law states that most nonproprietary ATM's provide immediate or close to immediate availability on funds.

So the concern that he is raising is apparently a concern among a minority of nonproprietary ATM operators.

And, obviously, if the majority of those operators feel that it is safe to make almost immediate availability, then, one, we think that is a big strike against their arguments, since there shouldn't be disparate situations among nonproprietary ATM operators. If it is safe for one group, it is safe for the minority of groups.

Senator DIXON. Would you excuse me for just a moment?

[Discussion off the record.]

Senator DIXON. OK. Now let me see. Let me just follow up on that with you, Ms. Meier.

If I understand what Mr. Cole is saying, he is saying with reference to a nonproprietary ATM, that they would suggest that it is kind of similar to an out of town draft, or something of that sort. And that that distinction has substance, that there is more opportunity for fraud, you understand, because of the passage of time.

Ms. MEIER. No. That is——

Senator DIXON. Is that a misinterpretation of what he is saying?

Ms. MEIER. I think it is a misinterpretation.

Senator DIXON. What do you think he is saying?

Ms. MEIER. Before we discuss their argument, you have to realize that for a bank to figure out what kind of a hold to place on a check under the act, it has to know what type of check it is, whether it is local or nonlocal as defined under the act, or whether it is a special class check, the next day checks.

What they are arguing is that nonproprietary ATM operators don't distinguish among types of checks. That is their current operating procedure. So they can't apply the holds as required under the act because they just don't—at this point, they don't know what kind of checks they've got.

Senator DIXON. I thought he was saying more that the institution itself did not know—if the deposit was in the nonproprietary ATM—because there was no systematic way of making that available, except at a tremendous cost.

Ms. MEIER. I guess you could look at it that way, that because it is deposited into an institution, physically into a facility owned by an institution that is not actually the account-holding institution, then there is a necessity to transmit the information.

So, yes, there is at this point in time two technologies that would need to be put into place. Not necessarily newly developed. They just need to be put into place.

One, is to distinguish checks. They don't distinguish checks right now like other banks have to.

And, two, after they distinguish the checks, they have to transmit that information to the account-holding institution.

Now there is not a technology problem here. And that is what I wanted to interrupt on before, because the discussion was all related to one possible solution, which is replacing the ATM hardware.

Senator DIXON. You're saying you could do this the same day anyway?

Ms. MEIER. I am saying, one, that there is no need to develop new technology to figure out the length of hold, because banks do that—banks that are not nonproprietary ATM operators, have to do that under the act. And those banks are not complaining. They are able to distinguish which checks get what hold period.

So it is not new technology. It is just a new procedure that would have to be adopted by nonproprietary ATM operators.

So they would have to do that. And then, second, they would have to transmit that information once they get it to the account-holding institution. And that does not require new technology either. All that requires is a change in operating procedures because they don't transmit that information now.

They do transmit information electronically to the account-holding institution already. They transmit the dollar amount and the date of deposit.

So they would simply need to add to that electronic transmission the hold period.

So, yes, changing the ATM hardware systems is one solution. But, yes, I don't think that that is the best solution and it is probably a costly solution.

But there are other, far less costly, solutions that require ATM's to act like other banks. Now they don't have to follow the schedule, they don't even—they are not even having to comply with the requirements that other banks have to comply with in terms of processing checks.

And, two, to transmit that information to the account-holding institution.

So, the new technology is not a requirement, what is required is just modifying some procedures that they don't want to do.

Senator DIXON. I guess what you are probably suggesting to the Chair is that, in the end, they're really not going to close these things. They're going to find a way to do this and get the information so that they can reduce the opportunity for fraud.

But, to be again the devil's advocate, what about his contention that there is a big cost here? And if there isn't an accommodation made to take into account the problem involved in the nonproprietary ATM, that, in fact, the cost is so great that they just won't do that?

That would be an unfortunate thing for the consumer, I take it.

Ms. MEIER. If they didn't provide deposit services at nonproprietary ATM's, I would say that that would be a disadvantage. And you're right. Our bottom line is we don't believe that the cost is substantial enough that that doom and gloom scenario, or whatever, will actually occur.

And also I'm trying to explain that I don't believe the cost associated with some of the potential solutions are necessary because those are not the cheapest solutions here. And the cheapest solution, which is simply adding information to that electronic transmission, which is a one-time cost, it is not a recurring cost, is not a significant cost.

Senator DIXON. Mr. Mierzwinski, first of all, Governor Angell suggested that you had your 80 percent mixed up, that, in fact, it isn't true that 80 percent have really shortened the time.

What do you say to that?

Mr. MIERZWINSKI. I would tend to clarify my statement——

Senator DIXON. I notice you made some clarification, but you certainly didn't say, as he suggested, that the reverse is true, I take it?

I think his suggestion was in his testimony that, in fact, the time has been lengthened by the passage of this act rather than shortened.

Mr. MIERZWINSKI. He may have data that suggests that the—if you say that 80 percent of the institutions either have the same or a shorter hold period, under their interpretation of that, would interpret that at least 20 percent have a longer hold period.

They would, I presume, then say that the 20 percent is greater than the portion of the 80 percent that has shortened their period. And that the rest have the same.

I don't have as much information as they do. All I have is their report. So I don't know whether or not that is true. That was my point.

It may be their position but, again, I balance the fact that 80 percent have either a shorter period or the same period with the infor-

mation that the other consumer groups provide me from around the country, which is that consumers like the law.

So that, in general, we are happy with it.

Senator DIXON. Excuse me just a moment, folks.

[Discussion off the record.]

Senator DIXON. Ladies and gentlemen, I think what we will do, we will resolve this in about a month or so. I think you probably all would like to know what is going to happen here.

And I think what we will do—there was some discussion that we might resolve this in connection with other legislation. We may, but we may not.

But I think that I will bring it to a conclusion. I think these things are the kinds of things that ought to be brought to a finite conclusion.

And we will try to do that in 30 days or so. Don't hold me precisely to that—by the end of March. But, in that timeframe, or something close to it.

I'm going to have some written questions for the five of you. If you would be kind enough to respond in short order, because we want to analyze that in arriving at the decision that the subcommittee will make in connection with all of these policy issues.

I thank you very much, and this meeting is adjourned.

[Whereupon, at 3:25 p.m., the committee adjourned.]

[Response to written questions of Senators Dixon and Bond with additional material supplied for the record follow:]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

March 19, 1990

WAYNE D. ANGELL
MEMBER OF THE BOARD

The Honorable Alan J. Dixon
Chairman
Subcommittee on Consumer and
Regulatory Affairs
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510-6075

Dear Mr. Chairman:

Enclosed are the responses to your recent questions regarding the Board's assessment of the Expedited Funds Availability Act and our proposed amendments to the Act. The Board appreciates the initiative that you have undertaken to assess what changes to the Act should be adopted to decrease the costs and risks to depository institutions without jeopardizing the Act's objectives.

Sincerely,

Wayne Angell

Enclosure

Q1. In your discussion of the amendment requiring Treasury checks and on-us checks to be deposited in staffed teller facilities, you claim that depository institutions are unable to verify the contents of deposits made at proprietary automated teller machines (ATM's) in time to provide next-day availability for these deposits. Why is this so? Consumers Union testimony claims, "Checks deposited into proprietary ATM's can be immediately processed by the owner of the ATM just as if they were deposited into a live teller window." What is your reaction to this?

A1. In response to proposed Regulation CC, which extended the next-day availability requirement to deposits made at proprietary ATMs, 164 of the 179 commenters who addressed this issue stated that it was difficult to verify the contents of deposits at off-premise proprietary ATMs before the opening of the next business day. This problem exists for Treasury and on-us checks as well as other types of checks that must receive next-day availability, such as cashier's checks. Due to these operational concerns and because the Act allowed institutions to condition next-day availability on the deposit being made at a staffed teller facility, the Board added this condition to its final regulation. We do not know whether the operational difficulties cited by the commenters in 1988 have subsequently been resolved.

Q2. On balance, do you believe that the Expedited Funds Availability Act is a net positive or net negative? Certainly the improvements in the check return system are a positive development, as well as the shorter holds institutions that were imposing unreasonably long holds. Do these benefits outweigh the costs borne by the industry in complying? Will these costs decline over time?

A2. While the Board agrees with Congress' goal of expediting funds availability, the Act has unnecessarily imposed burdens on depository institutions that appear to be disproportionate to the availability gains that have been realized by their customers. Nevertheless, some of these cost burdens were one-time nonrecurring costs. Further, both banks and their customers have benefited from the improvements to the payments system that are made possible due to the Board's expanded authority. We believe that this authority will enable the Board to make further improvements over time that will also benefit banks and their customers.

Q3. Please provide any survey or other objective information which backs up your contention that depository institutions lengthened their hold periods after passage of the Act. What percentage of depository institutions lengthened their holds? What percentage shortened their holds? Please comment on the divergent statistics from the Federal Reserve's 1989 report

and the 1988 Banking Administration Institute study (cited on page 6 of the banking industry testimony).

A3. In my testimony, I indicated that some institutions actually lengthened the holds they place on deposits in response to the Act. The survey results included in the June 1989 report to Congress indicated that two-thirds of the 521 respondents had explicit hold policies prior to the Act. Of these institutions, 47 percent indicated that their policies did not change, 40 percent indicated a net improvement in availability, and 13 percent indicated that they lengthened their hold policies when the Act took effect. Of the respondents that previously did not have formal hold policies, 35 percent indicated that their current policies provided for generally longer holds on deposits than was the case prior to the Act, and 65 percent indicated that they generally provide better availability as a result of the Act.

The banking industry testimony indicated that the BAI study found that most banks have policies similar to those they followed prior to Regulation CC. The BAI study may not be inconsistent with the survey results cited above; the survey data do not indicate whether the shorter or longer holds assessed by institutions in response to the Act are significantly different from their earlier policies or represent only minor modifications in policy.

Q4. The witnesses at the hearing disagreed substantially about the prevalence of fraud resulting from the Act. Your testimony suggests that the potential for increased fraud is what has prompted your proposed amendments, while the consumer groups state that this is not a problem. Is there any way the Federal Reserve could easily collect data on fraud losses? Would it be desirable for you and the other regulators to put another line on the call report for check fraud? Does the Federal Reserve have any data on increased fraud losses at those institutions that have already implemented the permanent schedule?

A4. We have studied whether it is feasible to collect industry-wide data on check losses, given the increased risk resulting from implementation of the Act. The collection of meaningful fraud data would be difficult. Pre-EFA fraud data are only available on an anecdotal basis. Further, in order to determine whether particular requirements of the Act result in high levels of losses to the industry, loss data would need to be collected by: (1) the class of check deposited (e.g., government check, official check, local check, or nonlocal check), (2) the availability that had been provided (if a bank that provides immediate availability for deposits incurs a loss, the loss may be attributable to the bank's policy rather than to the Act's requirement), and (3) the means of deposit (e.g., at a

nonproprietary ATM or over-the-counter). Few institutions account for check losses at this level of detail; therefore, collection of fraud data would represent major accounting changes at institutions and a significant additional data gathering effort on the part of the Federal Reserve.

Q5. The testimony from the bankers states that the new account period should be lengthened from 30 days to six months because of fraud losses suffered by depository institutions due to new accounts. What is the Federal Reserve's position on this issue?

A5. The period of time within which banks should be able to apply the new account exception to discourage persons from establishing accounts for the purpose of committing fraud should be determined based on historical industry experience. We had expressed concern during the development of the legislation that the length of the Act's new account period was not sufficient, and agree with the industry that a longer period would be justified. Without a longer new account period, the industry will likely increase its credit standards for new accounts.

Q6. What are your views on the contention that long check holds protect institutions from losses due to insufficient funds but not from losses due to counterfeiting and forgeries? (See page 4 of Consumers Union testimony.) What does a depository institution do with a government check -- between the day of deposit and the start of the next business day which helps the depository institution avoid fraud losses? Do you have any data on fraud losses from next day items?

A6. Check holds can protect institutions from losses due to counterfeiting and forgeries in cases where the drawer (or purported drawer) of the check uses an account reconcilement system that identifies checks that are presented for payment for which there is no record of issuance. These systems are often used for checks issued by depository institutions, state and local governments, and corporations, and can be used to detect a number of forged or counterfeit checks before the paying bank's midnight deadline. Because paying banks are able to identify and return some counterfeit and forged checks promptly, the depositary bank has an opportunity to learn of a return during the hold period.

A depositary bank can do little to protect itself from fraud with respect to government check deposits for which it must provide next-day availability. For checks issued by the U.S. Treasury, the institutions have no way to determine whether the Treasury (or a government agency) actually issued the checks. For state and local government checks, the depositary bank could call the paying bank to obtain information regarding the check;

however, the paying bank generally would not have sufficient information to guarantee that the check will be paid when presented.

As discussed in the response to question 4, the Federal Reserve currently does not have any data that would isolate fraud losses from next-day checks.

Q7. Why is it necessary to extend the reasonable cause exception to government checks? This exception does not appear to be aimed at preventing fraud or forgery, but rather at uncollectability. Does not the current version of the Act legitimately distinguish between government and nongovernment checks on this basis? Does the Federal Reserve have any data on difficulties due to fraud or uncollectability encountered by institutions in dealing with all of the next day items?

A7. The Act distinguishes between government and nongovernment checks by prohibiting banks from applying exceptions, including the reasonable cause exception, to government checks. We do not believe this distinction is justified. Depositary banks may doubt the collectibility of a government check for a number of reasons, including suspected fraud or forgery, or because a check may be stale dated (i.e., subject to return because it was deposited too long after issuance). Application of the reasonable cause exception will protect the depositary bank from loss where the paying bank returns a government check within its midnight deadline. Without the application of this exception, a depositary bank may refuse to accept a government check for deposit if it has reasonable cause to believe the check is uncollectible. Such action would clearly not be in the interest of customers that are the legitimate recipients of these checks. Therefore, we believe it is appropriate to extend the applicability of the reasonable cause exception to government checks.

As discussed in my response to question 4, the Federal Reserve does not have data on losses due to fraud or uncollectibility specific to next-day availability checks.

Q8. Under the Act, the Federal Reserve is authorized to suspend the availability schedules for a certain class of checks if that class of checks is producing an unacceptable level of fraud losses. Why is this authority insufficient to protect the banking industry against large fraud losses? Since the rationale for your amendments is potential not actual fraud, does not it make sense to see if this fraud actually occurs before amending the Act?

A8. Because the Act prevents the Federal Reserve from suspending the availability schedules without evidence that "an unacceptable level of fraud losses" has occurred and evidence

that losses would diminish if the schedules were suspended, it would be difficult to exercise this authority to protect the banking industry against fraud losses. Determining whether an unacceptable level of losses has occurred effectively requires historical loss data, which are not available. Even if such data were available, once the Board received sufficient evidence of losses to justify a suspension of the schedules, the industry would have already incurred significant losses that could not be recouped. Consistent with the adage "an ounce of prevention is worth a pound of cure," I believe it would be far more prudent to eliminate clear opportunities for fraud, rather than rely on after-the-fact measures. In addition, I believe that it is the potential for fraud that leads banks to curtail basic banking services and that allowing banks the mechanisms to protect themselves from fraud will benefit consumers by allowing banks to expand these basic services.

Q9. Your testimony indicates that, when the permanent schedule becomes effective in September, depository institutions will be required to make funds available before they know whether a local check will be returned unpaid. What will happen as a result? Is there anything the Federal Reserve can do to improve the check collection process further so that institutions can find out more quickly whether a local check is good? Please elaborate on any other reasons why you believe that fraud will increase when all institutions implement the permanent schedule?

A9. I believe that the increased risk to banks resulting from the permanent schedule will likely result in greater use of creditworthiness criteria for transaction account customers, and consequently the denial of basic banking services to some individuals. There is little opportunity to accelerate further the regular check collection and return process for local checks in order to reduce the risk created by the permanent schedule.

The Board has issued for public comment a proposal to determine whether shortening the notice of nonpayment requirement for large-dollar checks would enable depositary banks to reduce their risk of loss on local checks of $2,500 or more under the permanent schedule without imposing undue burdens on paying banks. Comments received on this proposal were mixed, with many commenters stating that shortening the time for a paying bank to determine whether to return a check may not be feasible, and may result in an increased number of returned checks. Staff is currently analyzing the comments received and will bring a recommendation to the Board for its consideration within the next several months. Shortening the notice of nonpayment time for large-dollar checks, however, would not address problems with checks of smaller amounts.

We have anecdotal evidence that some banks experienced significant increases in check losses when their state adopted funds availability legislation. These banks have indicated that they believe similar increases in losses will occur when the permanent schedule becomes effective. I believe, however, that institutions will narrow their deposit base with each fraud increase so that the Board may never receive meaningful data on the impact of the Act's requirements on institutions and their customers.

Q10. The testimony from Consumers Union disputes the Federal Reserve's testimony that the notice requirements are costly, arguing that tellers can provide the notice at the time the deposit is made. They further argue that switching to a one-time notice system could be costly for a depository institution because of the need to keep track of customers who had received the one-time notice? What is your reaction? Please elaborate on the timing and form of the one time notice you propose. For example, would the notice be given at the time the account is opened or the first time that the depository institution invokes the exception?

A10. The Board proposed that the Act provide greater flexibility to the Board to tailor the exception notices to make these notices both more meaningful to customers and less burdensome to institutions. Providing notices of exception holds at the time of deposit may slow teller lines. Other notices are mailed to the depositor, in cases where the deposit is made at an ATM or other unstaffed facility, or where the bank does not have the facts upon which to make the determination to invoke the exception at the time of the deposit. These notices involve exception handling and additional postage costs. In addition, regardless of the form of the notice, institutions must keep track of customers who are subject to the exceptions. It does not appear that these tracking systems would be more difficult if one-time notices were allowed.

While the Board has not yet considered what specific regulatory proposals it would issue to improve the current notice system, the following is an example of the type of amendments that may be proposed. The Regulation could permit a bank to satisfy its notice requirement by sending to a customer that has triggered the repeated overdrafter exception a notice indicating the longer holds that will be in effect for the following six months. Other exceptions may warrant differing approaches. Clearly, if proposed modifications to the notice requirements were perceived as more onerous than the current requirements, they would not be adopted.

Q11. How would you answer the contention that a longer hold period for deposits to nonproprietary ATM's is not necessary because "the operational systems that shared ATM operators need

to meet the permanent availability schedule are the same that depository institutions need for processing deposits obtained over the counter or through proprietary ATM's. They would simply need to put the checks through a sorter process...These difficulties are no greater simply because a check is deposited into a shared ATM?" (Page 9 of the Consumers Union testimony)

A11. The determination of the composition of the deposit at a nonproprietary ATM is made after the deposit information is sent to the account-holding bank. The deposit information sent electronically to the account-holding bank is essentially the information keyed into the ATM by the customer. The subsequent information flow between the nonproprietary ATM operator and the account-holding bank currently is limited to exception information (e.g., if the deposit amount keyed by the customer differs from the actual contents of the deposit or if a check deposited is returned unpaid). A requirement to expand the amount of information exchanged between the nonproprietary ATM operator and the account-holding banks would increase substantially the network communications costs and would require extensive programming on the part of all ATM network participants to prepare and accept new message formats.

The statement made in the Consumer's Union testimony that the nonproprietary ATM operator "would simply need to put the checks through a sorter process [to determine whether checks are local or nonlocal]" is incorrect. For many checks, such as credit union payable through drafts, the appropriate hold cannot be determined by the routing number printed in the MICR line of the check. The operator of a nonproprietary ATM would have to handle these checks on a manual exception processing basis to get the appropriate information to the account-holding bank before that bank completes the process of posting deposits to its customers' accounts.

Q12. Has the banking industry actually tested any of the proposed solutions to the nonproprietary ATM problem discussed in your report to Congress or are your conclusions based on projections and surveys from the banking industry?

A12. As stated in the Board's 1989 report to Congress on deposits at nonproprietary ATMs, some small networks serving limited geographic regions continue to use the method in which the ATM operator sorts and delivers unopened deposit envelopes to the account-holding banks. As networks grow in volume or begin to span larger geographical areas, they generally cannot employ this technique because it delays the processing and collection of checks. To our knowledge, none of the other system solutions has been tested by ATM networks because the solutions are considered cost-prohibitive.

Q13. If Congress passes the amendment making the temporary schedule permanent for deposits to nonproprietary ATM's will the Federal Reserve and the industry continue to work on innovations in shared ATM technology so that consumers can have access to their funds sooner? Would not passage of such an amendment eliminate the incentive for such innovation? Would not a temporary stay of the permanent schedule be preferable?

A13. The Board believes that the industry will continue to work on innovations in shared ATM technology so that consumers can have faster access to their funds. Institutions believe that, as technology improves, shared and proprietary ATMs will provide a more cost-effective way to provide banking services to their customers and thus have an incentive to make ATM services attractive.

The Board does not believe it would be desirable for Congress to adopt only a temporary solution to the nonproprietary ATM problem. The pace of technological improvements cannot be effectively predicted; therefore, the date by which improvements could allow for the expiration of a temporary stay is unknown. Under the proposed amendment, consumers would continue to be able to choose between the convenience of making a deposit at a nonproprietary ATM and the marginally prompter availability that may be provided if the deposit were made by other means. If Congress were to enact a temporary stay, the uncertainty of whether a technical solution could be found and implemented by the end of the stay could jeopardize the availability of this convenient service to customers or discourage ATM networks that do not currently provide shared deposit-taking function from enhancing their services to facilitate such activity.

Q14. Other testimony states that the Federal Reserve has reported that most ATM networks make deposited funds available on an immediate or next day basis without suffering losses. If this is true, why would these institutions do this? Why should Congress change the rules?

A14. As discussed in the response to question 12, institutions that provide same-day or next-day availability for nonproprietary ATM deposits generally provide the same prompt availability for other deposits as well because they know their customer base and consider them to be low-risk. Other institutions, primarily those located in large metropolitan areas that have experienced higher levels of fraudulent activity, believe that an immediate or next-day availability policy would subject them to a greater risk of loss. Congress recognized that these institutions, as a prudent measure to control this risk, should have the ability to impose reasonable holds on deposits they receive. If a bank imposes differential holds on local and nonlocal checks deposited over-the-counter, but must make all nonproprietary ATM deposits available within the time frame

required for local checks (which is the only practical means of complying with the permanent schedule), the protection gained from its general availability policy is eliminated. Congress should adopt the Board's nonproprietary ATM amendment so that institutions are not forced to make of choice between accepting a higher degree of risk or curtailing a service valued by their customers.

Q15. If one of your proposed amendments is adopted, then only $5000 of a cashier's, teller's, or certified check would be made available the next day. Why would a customer pay the fee to get this type of check if the full amount would not be made available the next day? Are not better ways available to protect against fraud with depository checks? What would a depository institution have time to do if this amendment were adopted which it cannot do now?

A15. Customers would continue to find these checks valuable in transactions where the payee demands payment by official check. A payee that currently requests payment by this means would be aware of the policy adopted by its institution and, if subject to the large-dollar exception, could request a wire transfer if next-day availability were required on amounts in excess of $5,000. Where customers use such checks to transfer their own funds, they would continue to be assured of next-day access to the first $5,000.

During the comment period on proposed Regulation CC, the Board explored ways for depositary banks to protect against fraud on depository checks, including requiring paying banks to respond timely to inquiries on such checks. However, it is difficult for banks to accumulate and report on these checks promptly after issuance. Time zone differences further exacerbate the difficulties in providing a timely response. Moreover, the depositary bank could not rely on a response received by the paying bank, because the paying bank could learn information after responding to the inquiry which causes it to not pay the check.

As discussed more fully in the response to question 6, a depositary bank would better be able to protect itself from fraud losses from official checks if the safeguard exceptions were applicable to these deposits.

Q16. How do you reconcile the second day availability rule of Regulation CC, which requires next day items (except for Treasury and "on us" checks) to be deposited at a staffed teller facility, with sections 603(a) and 603(e)(2) of the Act, which allows depository institutions to impose a one-day hold only for deposits at nonproprietary ATM's? Does not this language imply that deposits at proprietary ATM's should be treated as deposits at staffed teller facilities? Please note that the conference

report states, "The conferees intend that ATM's located at or adjacent to a depository institution be treated the same as a manned teller station for the purposes of the availability schedule.

A16. The Act does not require next-day availability for deposits (other than Treasury and on-us checks) that are made at proprietary or nonproprietary ATMs. Section 603(a) of the Act sets forth the conditions that must be met for certain deposits to be accorded next-day availability. For most types of deposits listed, the Act provides, as a condition to next-day availability, that the deposit be "at a receiving depository institution staffed by individuals employed by such institution." The Board, in Regulation CC, interpreted this condition to mean that the deposit must be made "in person to an employee of the depositary bank." Thus, because a deposit made at a proprietary ATM is not made at a staffed teller facility, it generally is not subject to the Act's next-day availability requirement. Section 603(e)(2) of the Act provides for second-day (or one intervening business day, in the Act's parlance) availability for deposits at nonproprietary ATMs that are otherwise generally subject to next-day availability. The Board believes it has properly interpreted and implemented these statutory requirements.

Q17. The Credit Union National Association (CUNA) testified that payable through share drafts generally are cleared as quickly as local checks because of the centralized electronic clearing system which credit unions employ. Furthermore, as of February 1, 1990, credit unions assume the risk, why do receiving depository institutions need to determine whether a payable through is local or nonlocal? Why do you believe that your proposed payable through amendment is still necessary?

A17. The primary reason the Board proposed the payable through draft amendment is the continuing difficulty experienced by depositary banks in determining in a cost effective manner whether checks are local or nonlocal. The only means of making this determination on an automated basis is to rely on the routing number of the paying bank encoded in the machine-readable MICR line on the check. Because the routing number in the MICR line of payable through drafts is that of the payable through bank, and not the credit union, and because the MICR line does not identify the check as a payable through draft, there is no longer any accurate automated means to ensure all checks are properly identified as local or nonlocal. This operational difficulty was not alleviated by the amendments to Regulation CC adopted by the Board last summer.

Even though the depositary bank is protected from longer returns because the check is sent to a nonlocal payable through bank for collection, the depositary bank is exposed to civil liability for incorrectly placing longer holds on local

payable through checks. This amendment would alleviate the risk of this civil liability.

Q18. Last July the Federal Reserve adopted--with CUNA's support--a requirement that payable through drafts be conspicuously labelled as of February 1, 1991. Why cannot the Federal Reserve design a machine readable system to differentiate these drafts from checks whose routing number can be used to determine local versus nonlocal status? Alternatively, why do you believe that having tellers manually separate these drafts is insufficient?

A18. In conjunction with its consideration of proposed amendments to Regulation CC to address the CUNA court decision, the Board considered several options suggested by commenters to determine, in a machine-readable manner, whether payable through drafts were local or nonlocal. The Board concluded that these options would not provide a cost effective solution to the problems created by the court's ruling, because of the costs they would impose on depositary and other collecting banks.

It is very cumbersome to address this problem by having tellers manually outsort payable through drafts. Institutions indicated that this process may further slow teller lines, and that they were concerned about relying on inexperienced tellers to make this differentiation. For many banks, an outsort of these drafts at the teller window would make more complex the proof of deposit function, where the deposit slip total is verified against the components of the deposit.

Q19. If any witnesses made statements at the hearing which you believe merit factual clarification, kindly provide such clarification. For example, contrary to one witness's testimony, does not Regulation CC already provide a definition of "repeatedly overdrawn account?"

A19. Regulation CC does include a definition of a repeatedly overdrawn account. Generally, if a customer overdraws its account or bounces checks on six days during a six-month period, the customer is considered a repeated overdrafter. A customer is also considered a repeated overdrafter if it overdraws its account or bounces checks in the amount of $5,000 or more at least twice during a six-month period. In these cases, a depositary bank may impose the repeated overdrafter exception for the next six months.

In a discussion of the nonproprietary ATM amendment, one witness noted that IBM had developed an ATM that would capture information that would enable the account-holding institution to determine the availability that must be given for the deposit. These ATMs capture the MICR-line information on deposited checks; unfortunately, due to the CUNA court decision,

this information is not sufficient to determine the availability that must be accorded check deposits.

RESPONSE OF

DAVID WITTMAN

REPRESENTING AMERICAN BANKERS ASSOCIATION
AND CONSUMER BANKERS ASSOCIATION

TO QUESTIONS FROM
SENATORS ALAN J. DIXON AND CHRISTOPHER S. BOND

Q1. **If one of your proposed amendments to the Expedited Funds Availability Act is adopted, then only $5,000 of a cashier's, teller's, or certified check would be made available the next day. Why would a customer pay the fee to get this type of check if the full amount would not be made available the next day? Are not better ways available to protect against fraud with depository checks? What would a depository institution have time to do if this amendment were adopted which it cannot do now?**

A1. Customers paying the fee to buy this type of check are often not the persons depositing the check and therefore are not as concerned about the availability of the checks. A person without a checking account may use a cashier's check for the same reasons a money order is used: to transfer money in a safe manner. A person may also use a cashier's or similar check because the recipient of the check insists on this type of payment. For instance, a seller, a landlord, or creditor may demand that payment be rendered by cashier's or similar check. In these cases, the recipient wants a guarantee that funds are available. These recipients usually are confident about the identity and character of the person presenting the check.

In contrast, banks are not in the same position as other recipients of cashier's and similar checks to evaluate the identity of the person presenting the check or the likeliness that such person is involved in check fraud. Moreover, banks are natural targets for fraudulent cashier's and similar check scams because the holder of the check receives cash rather than merchandise which is less transferable and will help to locate the perpetrator of the fraud.

Anyone accepting <u>any</u> check wishes to be certain that: 1) funds are on deposit to pay the check; 2) the person presenting the check is the same person identified on the check; and 3) such person is not involved in check fraud. Presenting a cashier's check or similar check satisfies the first concern since the certified or cashier's

label guarantees that if the check is not counterfeit or falsely endorsed, the check will not bounce because funds to pay the check are available in the account.

The assurance that the check will not bounce is the reason sellers frequently insist that payment be made in the form of a cashier's or similar check. Recipients of these checks also need assurance of the buyer's identity and character, but sellers accepting these checks, for instance, are often in a position to verify with reasonable certainty the person's identity, particularly if the transaction involves a major purchase such as a car or house. In these cases, recordation or registration of ownership demands proof of identification. In addition, such transactions often involve a loan. The consumer credit report ordered for that purpose can verify the buyer's identity as well as the person's credit history. The recordation process and the consumer reports help the seller to confirm the identity of the buyer as well as evaluate the character of the buyer.

Moreover, the likelihood that a buyer will use a fraudulent check is reduced in transactions involving recordation or registration because the buyer can be located more easily and prosecuted for a criminal offense. While a person who bounces a check may still owe the money to the seller, that person is not usually prosecuted for criminal fraud as is the case for passing fraudulent checks.

Those who insist that payment be by cashier's and similar checks who are not involved in a major purchase transaction require them for the same reasons. They seek a guarantee that funds are on deposit to pay the check. In these instances, the recipients of the check are usually in a position to confirm the identity of the person presenting the check and to evaluate whether the person is likely to be involved in check fraud. For instance, a landlord may insist that payment be made in guaranteed funds. A plaintiff in a legal settlement or lawsuit may demand a cashier's or similar check to avoid further action if the check should bounce. A creditor may insist that a late payment be by cashier's check in order to avoid foreclosure. It is unlikely in these cases that the payor will use a fraudulent check due to the ability of the recipient to locate the payor, the possible criminal liability, and other consequences of passing a fraudulent check. The most critical issue for the recipient of the check is whether funds are available. Accordingly, they require cashier's or similar checks.

In contrast, banks are not in the same position as other recipient's of cashier's and similar checks. Consequently, banks are attractive targets as conduits for fraudulent cashier's and similar check scams and need the

discretion on a selective basis to impose holds on large dollar cashier's and similar checks.

Account holders are usually ensured of a certain degree of anonymity because they are one among many account holders. Less is known to the bank about them because their credit reports are not reviewed as they are when a person applies for a car or home loan. In addition, there is less to connect the depositor of a cashier's check to the bank for purposes of locating them or any money released upon discovery of the fraudulent check. For example, there is no car or car registration or home related to the transaction. For these reasons, it is far more attractive to deposit fraudulent cashier's checks into a bank account and gain transferable funds than use them to purchase traceable merchandise.

Undertaking a fraudulent check scam can be relatively simple. An individual opens an account and maintains the account properly for at least 30 days so that it is no longer characterized as new. The account holder then deposits a large cashier's check for tens of thousands of dollars. The following day the person can withdraw the entire amount of the check, before the bank has the opportunity to discover the fraud and block the withdrawal. One large loss, particularly for a small bank, can be significant.

The most effective way to minimize this loss is to place holds on a selective or routine basis on amounts above $5,000. While new technologies to protect the integrity of checks are constantly being developed and implemented, check fraud artists inevitably devise ways to circumvent them.

The longer holds permitted under an amendment would allow additional time to discover the fraud and to relay the information to the bank of deposit before the depositor may demand to withdraw the funds. Depending on the sophistication of the fraudulent check, the fraud may be discovered at different stages in the check collection and return item process. For example, the fraud can be discovered early in the process at the processing center or later when it reaches the paying bank.

If the problem is discovered early, a hold can be placed before funds must be released under the current schedule, i.e. the day following deposit. If, however, the fraud is not uncovered until the check reaches the paying bank, under the current schedule, it is unlikely that the paying bank will be able to notify the bank of deposit that the check is not payable before that bank must release the funds. If the amendment were adopted, in most cases, the paying bank would be able to notify the bank of the uncollectibility before funds must be released. In such a

case, if the bank of deposit had placed, for example, a four-day hold on the amount over $5,000, its risk of loss would be limited to $5,000. While there may continue to be instances when the fraud is not discovered until after funds must be released, the amendment will reduce significantly the risk of loss due to fraud and also serve to discourage those interested in depositing fraudulent cashier's and similar checks.

Q2. **How would you answer the contention raised in the Consumers Union testimony that hold periods are useful in protecting depository institutions from losses due to insufficient funds but that they are not useful in protecting depository institutions from losses due to forgeries or counterfeiting? What does a depository institution do when a government, cashier's, or certified check is deposited to determine whether or not it is counterfeit or a forgery? Do you have any data on fraud losses from the next day items?**

A2. Holds are without doubt useful in preventing losses due to forgeries and counterfeiting. As discussed above, the forgery or counterfeit character can be discovered at various stages of the check process. Not all checks will be discovered within the periods allowed by the amendment, but many will be. Also, the ability to place the hold serves as a deterrent to those contemplating check fraud using these types of checks.

There are various ways for banks to discover that a check is counterfeit or photocopied well within the hold periods permitted under the amendment. However, we do not wish to disclose in a public document the means to circumvent measures designed to discover counterfeit or forged checks. Obviously, public knowledge of such information will defeat its purpose. We will be happy to discuss the subject in private meetings.

Q3. **Why are depository institutions unable to verify the contents of deposits made at proprietary automatic teller machines (ATMs) in time to provide next-day availability for these deposits? Why should it be necessary to deposit Treasury checks and on-us checks at staffed teller facilities?**

A3. Often, the deposits are verified and posted to the account in time to allow next-day availability. For this reason, many banks make funds from checks deposited into ATMs available on the day following deposit. However, there are situations when this is not the case. For example, remote ATMs with few transactions may not be serviced as frequently as a high transaction volume ATM. It may not be

economically justifiable to collect deposits and replenish cash on a daily basis. In these cases, deposits will not be verified in time to allow next-day availability.

Furthermore, in many cases when funds from ATM deposits are available on the day following deposit, the depository institution is releasing funds before it even receives provisional credit. Depending on the time ATM deposits are collected and the bank's particular processing procedure, the ATM deposits may not be processed before the depository institution's transit deadline to send the checks to its correspondent bank. In these situations, if the funds are available on the day following deposit, the customer has use of the funds before the depository institution has even received provisional credit. For these reasons, many banks choose to make ATM deposits available on the second day following deposit.

The amendment recommended in our testimony would not require that Treasury checks and on-us checks be deposited at staffed teller facilities. The amendment would only relieve banks from having to provide next-day availability on the checks. Instead, the amendment would, in effect, require that funds from these deposits be available on the second day following deposit. This second day availability schedule for certain ATM deposits already applies to funds from other items such as cashier's checks which are subject to next-day availability when deposited at a staffed teller facility.

Q4. **What percentage of depository institutions lengthened the holds they placed on deposits as a result of the Act? What percentage shortened the holds?**

A4. We do not have any data specifically measuring the percentage of depository institutions which lengthened the holds they place on deposits as a result of the Act. Preliminary results from a recent ABA survey show, however, that the policy of 81 percent of 961 banks surveyed was generally to provide funds on the day of deposit or the day following deposit.

Q5. **Testimony from Consumers Union disputes the Federal Reserve's testimony that the notice requirements are costly, arguing that tellers can provide the notice at the time the deposit is made. Also, switching to a one-time notice system could be costly for a depository institution because of the need to keep track of customers who had received the one-time notice. What is your reaction?**

A5. First, the costs associated with providing the notice at the teller window is not limited to the cost of devising

and printing the paper notice. Other costs include, for example, the teller's time spent to complete the notice and explain it to the customer if necessary and the time spent to educate tellers on the procedures for placing a hold and furnishing the notice. Obviously, mailing the notice entails other costs.

Second, tellers cannot always provide the notice of exception at the time the deposit is made. Under the Expedited Funds Availability Act and Regulation CC, depository institutions must provide the notice of a hold at the time of deposit or they must mail the notice. Tellers often are not the ones deciding to place holds unless perhaps it is a routine hold on an easily identifiable type of check such as a check above a certain amount. Depository institutions often do not wish to grant tellers the discretion to place subjective holds. Instead, the teller is required to consult a person responsible for making the decision in the event the teller is unsure about a particular check. The person responsible for making the decision may not be available when the deposit is made, particularly if it is during the busy hours. Other times, the decision to apply an exception to the schedule is made after the deposit by someone other than the teller who is qualified to review the check and make the decision.

The preliminary results of a recent ABA survey show 58 percent of the 717 banks surveyed most often provide the notice of exception by teller, 34 percent most often provide the notice by mail. The preliminary results of a recent ABA survey found that the average cost of providing the required notice was $2.75.

Keeping track of which customers have received a one-time notice is no more burdensome than tracking which accounts are subject to longer holds because an account has been repeatedly overdrawn. Under the amendment, once an account has been "repeatedly overdrawn" as defined by Regulation CC, the depository institution could send a notice that for a specified period, checks will be held according to a longer funds availability schedule as outlined in the notice. Assuming no further problems with the account, the longer schedule would expire after the stated period.

Q6. **How would you answer the contention that it is not necessary to allow a longer hold period for deposits to nonproprietary ATMs because "the operational systems that shared ATM operators need to meet the permanent availability schedule are the same that depository institutions need for processing deposits obtained over the counter or through proprietary ATMs. They would simply need to put the checks through a sorter process... These difficulties are no**

greater simply because a checks is deposited into a shared ATM"? (page 9 of the Consumer's Union testimony)

A6. I would reply that the contention is incorrect. At some point in time, yes, almost all checks go through a sorter process in order to reach the paying bank. However, they are not necessarily processed in a manner to distinguish local checks from nonlocal checks in an automated fashion. In some banks, the determination is manual. The steps leading up to the sorting process, as well as other requirements, differ depending on how the check was deposited.

The simplest transaction is an over-the-counter deposit. The check is verified by the teller, who may determine whether it is a local, nonlocal, "on-us," etc. check. The teller then keys in or writes down such information for posting purposes. The check is thus already identified as local or non-local and ready to be deposited in the check collection process. In some banks, someone other than the teller makes the distinction. Other banks perform this function in an automated fashion.

In the case of deposits made at proprietary ATMs, the bank that owns or operates the ATM generally removes the deposit envelopes from the ATM, opens and verifies the contents of each envelope, performs the proof-of-deposit function, prepares the checks contained in the deposit for collection, and posts to the customer's account from the actual deposit. Generally, the account-holding bank has the ability to ascertain the composition of deposits made at proprietary ATMs and, thus, is able to apply differential hold and invoke the exceptions contained in the Act.

In contrast, deposits made at a nonproprietary ATM are removed and processed by the ATM operator (<u>or in the case of off-premise ATMs, by a third-party service-processor</u>),* rather than the account-holding bank. The deposit envelopes are opened and verified, and the checks contained in the deposit are prepared for collection. An electronic message is forwarded to the customer's bank notifying it of the date, time, location, account number, and aggregate amount of the deposit, as keyed into the ATM by the customer. The customer's bank posts the deposit to the customer's account based on the information contained in the electronic message. In the event of a discrepancy between the deposited amount entered by the customer and the actual amount of the deposit, as verified by the ATM operator, adjustment entries are transmitted by the ATM operator to the account-holding bank. In the case of nonproprietary ATM deposits, the account-holding bank cannot ascertain the

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* Parenthetical clause added

composition of the deposit (i.e., whether the deposit consists of cash, checks generally subject to next-day availability, local checks or non-local checks) and therefore cannot apply differential holds or invoke any of the Act's exceptions.**

This description applies generally to processing of ATM deposits. Procedures do vary, however, from institution to institution.

Banks try to provide availability on deposited funds as efficiently, economically, and safely as possible. The shared ATM environment exacerbates the bank problems in the following areas:

- o data capture;
- o communication of data; and
- o analysis of data.

Capturing the data is the simplest. In a shared ATM environment, however, it is labor intensive and very costly. In addition to verifying the amount of the deposit, the ATM owner must have individuals who actually determine whether the checks are local or nonlocal and then prepare them for collection. One local bank has reported that it has recently adopted such a procedure, assigning availability differentials to proprietary ATM deposits. As a result, the ATM servicing costs have doubled. Technological advances such as the IBM reader discussed in the answer to question eight may alleviate some but not all of the problems in this area.

The remaining two areas, communication of data and analysis of data, are more complicated. In an on-line environment, only the information keyed in by the customer using an ATM operated by Bank A is directly communicated to the account holding institution, Bank B. No information on the types of checks is transmitted. Bank A then verifies the deposit, sends the checks for collection and only notifies Bank B if there are discrepancies.

The communication of the data involves telecommunication lines. Networks do not want to tie up lines with additional information, since it causes delays. ATMs are marketed as a fast and convenient banking service. It is in the best interest of the networks, banks, and customers to complete a transaction quickly. As a result, networks place a premium on the time a transaction takes to be completed. Some networks even penalize ATM operators

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** Board of Governors of the Federal Reserve System Deposits at Nonproprietary Automated Teller Machines to Congress (1989). (information in parentheses and underlined added)

when a transaction takes too long to complete. Others may reward ATM operators who consistently complete a transaction correctly and within a specified time frame.

Since speed is essential, the valuable telecommunication space cannot be filled with "garbage," i.e., non-essential information. Not only would additional information delay the transaction, it would also raise costs considerably. Sophisticated alternative communication systems, which to our knowledge have not been developed to any extent to date, must be in place to communicate the necessary information between institutions.

Systems to analyze the data, i.e., determine whether a check is local or nonlocal or if an exception applies needs to be developed. Moreover, such systems do not address the unique problems intrinsic to the current treatment of payable-through drafts. While the IBM equipment discussed in more detail in the answer to question eight is helpful, it cannot "read" properly the routing numbers to accommodate the share-draft payable-through items. Because the machine-readable MICR of payable-through drafts cannot be used to assign availability, all checks must be reviewed manually to determine whether the deposit is a payable through check before availability may be assigned in an automated environment.

Q7. Has the banking industry actually tested any of the proposed solutions to the nonproprietary ATM problem discussed in the Federal Board's Reserve report to Congress?

A7. The Federal Reserve Board identified the following potential solutions:

1. requiring the customer to identify the necessary information at the time of deposit;

2. modifying the ATM to capture information concerning the composition of the deposit;

3. having the ATM operator capture information concerning the composition of the deposit when processing the deposit and transmit this information to the account-holding bank;

4. establishing a clearing agent for the network; and

5. having the ATM operator sort and deliver unopened deposit envelopes to the account-holding banks.

At this point in time, none of the alternatives outlined above will solve the problem in an efficient and cost-effective manner.

We do not know of any institution or network willing to depend on the information keyed in by the customer. The fraud potential is too high. Even now, customers key in information indicating a deposit and then deposit empty envelopes. Unless the ATM could instantaneously read and verify the information, this alternative is not a solution.

Automated data capture is a possible solution that needs further exploration but, as discussed above, current treatment of payable-through drafts poses a significant obstacle. Automated data capture should be studied in conjunction with alternative communications so that the information can be communicated without interfering with the speed of the transaction. However, preliminary reviews of this possible option strongly suggest that the cost, efficiency, complexity, and consumer burden outweigh its usefulness. The banks' most practical choice may be to restrict or discontinue accepting deposits into shared ATMs.

CBA and ABA as well as the EFTA welcome the opportunity to continue to work with the Federal Reserve Board to reach a solution. CBA's EFT Committee include board members of SNEA (Shared Network Executive Association) as well as representatives from banks and ATM vendors. They have all expressed interest in continuing work on this issue. The other identified potential solutions are too costly and are unlikely to be adopted by the industry.

Q8. **If Congress passes the amendment making the temporary schedule permanent for deposits to nonproprietary ATMs, will the Federal Reserve and the industry continue to work on innovations in shared ATM technology so that consumers can have access to their funds sooner? Would not passage of such an amendment eliminate the incentive for such innovation? Would not a temporary stay of the permanent schedule be preferable?**

A8. An amendment to the Expedited Funds Availability Act making the temporary schedule permanent for deposits at nonproprietary ATMs will NOT eliminate initiatives for innovations in technology. Advancements in this area have been made, in part, in response to customer demand. Customers appear increasingly to want the convenience of "banking" at their ATMs. Accordingly, banks provide the ATM deposit feature as a convenience in spite of the cost and inefficiency of accepting deposits in this manner. Given the demand for the service and the cost of providing it,

banks have been and will continue to look for ways to improve the process.

To our knowledge, one manufacturer has developed a solution to some of the problems inherent in ATM deposit-taking. IBM offers "personal banking machines" - 4730S and 4732S which were the originally developed with the goal of replacing at least 80 percent of the work done by a teller. ATMs can "read" the MICR number on the check.

Both machines can take checks (although they must be fed into the machine individually) and they can be, in some instances, programmed to include a field that reads the amount of the check. This "image-type processing" is a technological advance that has been adapted to the ATM environment. Others will follow.

Unfortunately the IBM equipment cannot solve the problems raised by the local/nonlocal requirements of the EFA. These ATMs read the MICR number to determine the locality of the paying banks. Since the MICR numbers on credit union share drafts may be those of a payable-through bank located in another area, this technology in its present form cannot be used for <u>any</u> check (see response to question 13). In addition, the equipment costs considerably more than cash dispensing machines, requires additional training, and necessitates software changes.

The equipment continues to evolve. IBM's 4732 is only about one year old and it offers more flexibility than the older 4730 which is a stand-alone machine. The 4732 can be fitted in a wall and may be used more extensively in today's environment.

We do not believe that an amendment would in any way eliminate incentives to improve deposit-taking. While a temporary stay of the permanent schedules might be acceptable, it depends on the amount of time. One year is not enough. Innovations are motivated by the banking industry, consumers, and others -- including the Federal government -- who are exploring every possible initiative that increases efficiency in the check processing system.

Q9. **Why is it necessary to extend the reasonable cause exception to government checks? This exception does not appear to be aimed at preventing fraud or forgery, but rather at uncollectibility. Does not the current Act legitimately distinguish between government and nongovernment checks on this basis?**

A9. One of the intended uses of the "reasonable cause" exception is to limit losses on checks which may not be collectible because they are fraudulent. A depository

institution might place a hold, for example, if it has reasonable cause to believe that the check has been altered or the endorsements forged or that the check is a photocopy of a legitimate check. Treasury checks are just as vulnerable to these defects as other checks. They can be altered, photocopied, or stolen and the endorsements forged. In many cases, the defect will be discovered at some point in the check process and the bank notified within the hold periods which would be permitted under the amendment. Moreover, the ability to place the holds serves as a deterrent to abusing the funds availability schedules.

Q10. **The witnesses at the hearing disagreed substantially about the prevalence of fraud resulting from the Act. Your testimony suggests that the potential for increased fraud is of greater concern than existing fraud to date. Consumer groups, on the other hand, maintain that fraud is not a problem. Is there any way the Federal Reserve or your industry associations could easily collect data on fraud losses? Would it be desirable for the federal regulatory agencies to put another line on the call report for check fraud? Do you have any data on increased fraud losses at those institutions that have already implemented the permanent schedule?**

A10. As we stated in our testimony, data representing the industry in general measuring the check fraud losses are difficult to compile for a variety of reasons. Check fraud losses are reported differently from institution to institution. For example, losses from uncollectible checks may be assigned to the same category as other types of losses of the depository institution. Also, a single line on the call report for check fraud will not produce meaningful data in terms of evaluating the impact of Regulation CC. A report on the amount of fraud alone does not relay the cause of the fraud or whether Regulation CC contributed and how much. In order to be useful, the reports would have to include information on the specific funds availability policies of the depository institution before and after Regulation CC, whether that depository institution would have actually placed a hold but for Regulation CC, whether the hold would have in fact prevented the loss, and the type of check fraud involved. For example, if a depository institution wished to place a hold on a particular check but, due to the requirements of Regulation CC, allowed the depositor to withdraw the funds on the day following deposit and the check is returned unpaid, the depository institution could conclude that the loss was attributable to Regulation CC. However, if the check had been delayed in the return process reaching the bank of deposit long after the bank would have released funds absent Regulation CC, the loss is not a direct result of Regulation CC.

Individual banks with the resources and ability to analyze in detail their own check fraud losses have been able to evaluate the impact of Regulation CC and state funds availability laws. Many of these banks report increased losses.

The preliminary results of ABA's survey measures generally whether banks have experienced an increase in check fraud since implementation of Regulation CC. Seventeen percent of 964 banks responded that they had. However, this number does not necessarily account for those banks located in states which had passed their own funds availability laws prior to Regulation CC; the initial increase in check fraud may have occurred after the state law became effective. In addition, some large banks which have in recent years been the targets of check fraud scams have developed procedures and programs to identify and defeat such scams and therefore have actually decreased their overall losses from check fraud.

Q11. **What is your view of the Federal Reserve's proposed judicial review amendment to the Act?**

A11. In general, we have no objections to that amendment. We would, however, suggest that the language of the amendment be modified to clarify that if a party wishes to appeal, review by the district court is not optional, but mandatory. The proposed language, "Any party aggrieved ... may obtain a review ... in the United States Court of Appeals..." suggests that review by the court of appeals is permissive, not required.

Q12. **Your testimony cites data concerning the costs of implementing Regulation CC. Your sample included only two banks. Are these banks representative of the industry in general? Is any more industry-wide data available?**

A12. We do not have any additional formally collected data. The costs of implementation of a regulation necessarily must be documented at the time of the implementation process. It is impossible to reconstruct subsequently many of the relevant costs such as personnel time spent to review and implement policies. Many depository institutions, particularly small ones, do not collect such data on a routine basis. We believe, however, based on the reports of individual depository institutions that in general, the costs reported by the three banks noted in our testimony are fairly representative of the industry.

Q13. **As you know, the Credit Union National Association successfully sued the Federal Reserve over the treatment of**

payable-through drafts under the Act. Please explain your support of the amendment which would reverse that court decision.

A13. The court decision ruled that a check is deemed local or nonlocal for purposes of the funds availability schedule depending on which bank issues the check, not the one to which it must be sent for payment. Thus, under the court's decision, a California bank which accepts a check issued by another California institution must treat the check as local and subject to local availability schedules, even though that check must travel to a New York institution for payment and logically should be subject to nonlocal schedules. Consequently, under these situations, the bank accepting the check for deposit is at much greater risk that it will release funds which ultimately are uncollectible.

The routing numbers on checks are based on the location of the institution to which the check is sent for payment. Generally, depository institutions use machines to read these routing numbers to assign availability, distinguishing between local and nonlocal checks. Because of the court decision, depository institutions may no longer rely on the routing number encoded on the machine readable MICR line to sort local and nonlocal checks. Instead, personnel in depository institutions must review each item visually to determine from printed information which is not machine readable whether the check is local or nonlocal. Such an exercise slows check processing, contrary to Congress' expressed intent in the Act that the Board take steps to modernize and accelerate the check payment system.

Response by Stephen S. Cole to Questions from Senators Alan J. Dixon and Christopher S. Bond

Question 1. Why cannot automatic teller machine (ATM) network operators process information about hold periods? Why cannot you, as other testimony suggests, put the checks through a sorting process and then communicate the hold information electronically along with other information so communicated? How much would processing and communicating this information cost?

Answer 1. It is difficult to understand how the nonproprietary ATM process works and even more difficult to illuminate the problem. When Institution A's deposit customer uses an ATM owned by Institution B the information currently received by Institution A is electronically transmitted from the nonproprietary ATM to Institution A at the time the customer is at the ATM and it is initiated by the customer pushing the keys on the ATM. Institution A learns the customer's identity from the card inserted in the machine and by the customer's personal identification number (PIN) which is entered using the keys. Institution A, similarly, learns the account into which the deposit is being made and the dollar amount of the total deposit.

Subsequently, Institution B removes the deposit envelope along with all others in the ATM, and checks the items in the envelope against the total amount entered by the depositor. If the amounts match, Institution B forwards the checks for collection. If they do not match, Institution B forwards the checks for collection but in addition it notifies Institution A of the amount of the discrepancy. There is no other communication between the two institutions relative to the specific deposit unless a check is returned unpaid.

This operating procedure has been developed because it provides the quickest, most efficient, least costly process to serve the consumer. This procedure could be modified for Institution B to provide to Institution A information needed to assign deposited items to the appropriate availability schedule. However, all such modifications involve networks and the efficient service they provide consumers.

One such modification would involve Institution B reviewing all checks that are deposited by customers of Institution A and the other 378 network institutions, in the case of Cash Station, and relaying the needed information to the depositors' institutions by telephone or by some other electronic means. Both methods required time-consuming and labor-intensive procedures. Also Institution B might sort the deposit envelopes placed in its ATMs by depositors of other institutions and deliver the envelopes unopened to the appropriate institutions. These alternatives would involve not only a significant increase in labor cost but also a critical time loss in collecting the checks thus increasing the risk of loss to the financial institutions, particularly as networks grow geographically and distances between institutions increase. We are talking about thousands of checks a day -- not a handful -- drawn on the financial insitution resident within any Federal Reserve District, not a handful. Further the additional processing costs would be borne by the owner of the nonproprietary ATM, not the institution whose depositor is being served.

Great progress has been made over the years in processing checks from the clearing houses and postal service. Serious considerations of any of these alternative procedures being adopted is to delay the check processing time and substantially increase customer costs and institution risk. Thus, depository institutions that take deposits today at nonproprietary ATMs may find they have no alternative, if the permanent schedule

is not changed, but to discontinue such deposit service to their customers. However, if the schedule is changed to treat all nonproprietary deposits the same as nonlocal checks then the consumer depositor could continue to choose between a convenient ATM owned by another institution or his or her own institution's ATM or branch.

Question 2. Other testimony states that the Federal Reserve has reported that most ATM networks make deposited funds available on an immediate or next day basis without suffering losses. If this is true, why would these institutions do this? Why should Congress change the rules of the Expedited Funds Availability Act?

Answer 2. In my testimony I discussed two such institutions that are in a shared network. Each institution, not the network, had voluntarily adopted the permanent schedule or given even prompter availability to serve their customers better. These actions were taken predicated on previous loss experience. Unfortunately, each sustained significant losses and has changed or is considering a change to the longer hold periods allowed by the temporary schedule. With the passage of time, crooks are becoming more familiar with ATMs, their procedures, and the opportunities they offer for fraud. Depository institutions should be allowed to take precautions against such fraud and allowed, within reasonable availability schedules, to assume a level of risk which they can tolerate and still provide consumers with a choice of services.

Question 3. Your testimony mentions that the technology does exist to read the contents of an ATM but it is in extremely limited use. Do you see any development on the horizon which would make this technology more widespread?

Answer 3. My oral testimony did not focus on the aberration of the credit union payable through draft. My prepared statement filed with the Subcommittee and my oral testimony dealt with available technology. Technological developments will

continue to increase over time with much focus on proprietary ATM programs. Regulation CC when originally issued provided that the determination of local or nonlocal in the schedule was to be based on the check's MICR number. In the case of credit union drafts, the MICR number identifies not the credit union but rather the bank through which the draft is to be paid. Often such banks may be in a different check processing region than the credit union thus the MICR may indicate a check is nonlocal when the credit union is just down the street from the ATM. The credit unions felt that this Regulation CC treatment of local checks as nonlocal checks gave other institutions a competitive advantage so they brought a law suit challenging Regulation CC.

The court agreed with the credit unions that Congress intended local vs. nonlocal to be determined by the actual location of the institution not by the MICR number on the check or draft. Thus credit union drafts must be physically read to categorize them.

Consequently, even if an ATM network utilized nothing but IBM 4730s an institution that was serious about compliance with the Act and Regulation CC would have to give second day availability on all nonproprietary ATM deposits unless the permanent schedule is changed.

Question 4. How would you answer the contention that it is not necessary to allow a longer hold period for deposits to nonproprietary ATMs because "the operational systems that shared ATM operators need to meet the permanent availability schedule are the same that depository institutions need for processing deposits obtained over the counter or through proprietary ATMs. They would simply need to put the checks through a sorter process . . . . These difficulties are no greater simply because a check is deposited into a shared ATM"? (page 9 of Consumers Union testimony)

Answer 4. Such an argument is specious and is reminiscent of the argument that increased reporting requirements pose no burden on institutions because the information is already in a computer. As described in the answer to Question 1 the information would have to be collected by the institution that owns the ATM and the information relevant to other institutions in the network transmitted via telephone or data entry to those institutions or the deposit envelopes would have to be sorted and delivered to the appropriate institutions in the network wherever located. It is easy for one not required to perform a function to say there is nothing to it. It is another thing to carry out that function, particularly in view of the work hours that would be required and the time expended. In addition, the technologial message format utilized in a shared ATM network would have to be modified at great expense to all financial institutions and data processors.

Questions 5. Has the banking industry actually tested any of the proposed solutions to the nonproprietary ATM problem discussed in the Federal Reserve report to Congress or are your conclusions based on projections only?

Answer 5. The Federal Reserve Board mentions in its 1989 Report that in the early days of shared ATMs, deposit envelopes were delivered to the depositors' banks. It also discusses how it was soon recognized, as network grew in size and geographical distance, that this procedure did not work and new procedures had to be developed. As a consequence we have today's procedure which serves the needs of the consumer as well as of the depository institutions.

Question 6. If Congress passes the amendment making the temporary schedule permanent for deposits to nonproprietary ATMs, will the Federal Reserve and the industry continue to work on innovations in shared ATM technology so that

consumers can have access to their funds sooner? Would not passage of such an amendment eliminate the incentive for such innovation? Would not a temporary stay of the permanent schedule be preferable?

Answer 6. As mentioned in my prepared statement, improvement in banking service always is driven by market pressures. The need to improve ATM services to consumers led to the formation of networks and to nonproprietary ATM services being provided to the consumer -- including deposit-taking. Such pressures will continue to push the improvement of procedures and systems including the technology needed to provide earlier availability. To doubt this, is to deny the past performance of our nation's depository institutions. A quick review of banking in 1960 and banking in 1990 shows clearly that progress will continue particularly if depository institutions are given the opportunity to deal with today's problems. A temporary stay may or may not give the time needed. It is doubtful, however, that it would give any greater incentive than the marketplace itself for improved technology.

Question 7. Has your organization prepared any estimate of the cost to consumers of financial institutions complying with the permanent availability schedule? Based on your practical experience, how likely is it that institutions would eliminate the deposit function at shared ATMs? How many customers would this affect?

Answer 7. Estimates of cost to comply with the permanent schedule as presently written have not been prepared because of the many unknowns such as loss experience. The decision on whether shared ATM deposits are to continue must be made by the depository institutions. As I said in my response to Chairman Dixon's question at the hearing. "It is probably likely that the institutions who sit on the board of directors (Cash Station) and set the policy for the network would strongly recommend

that effective September 1, that deposits cease to be an account function -- or a transaction -- that can be handled on a shared basis." In the case of Cash Station this could affect more than two million consumers. In the case of members of the Electronic Funds Transfer Association, 17.5. million consumers could be adversely affected..

Credit Union National Association, Inc.
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March 16, 1990

The Honorable Alan J. Dixon, Chairman
and The Honorable Christopher S. Bond,
Ranking Minority Member
Senate Subcommittee on Consumer and
Regulatory Affairs
530 Dirksen Senate Office Building
Washington, DC 20510-6075

Dear Senators Dixon and Bond:

The Credit Union National Association, Inc. and Affiliates (CUNA) appreciated the opportunity to appear March 1, 1990 before your Subcomittee to present its views regarding the regulation of payable through share drafts and other issues relevant to the implementation of the Expedited Funds Availability Act of 1987.

On behalf of CUNA, I am pleased to respond to the Subcommittee's request for further information on payable through share drafts. My answers are attached.

CUNA's written and oral testimony to the Subcommittee demonstrates the significant problems the Federal Reserve Board has attempted to create for payable through share drafts through its misinterpretation of the Act.

Credit union share drafts, the majority of which are payable through share drafts, provide an important service to consumers and afford them with an alternative to bank checking accounts. We thank the Subcommittee for allowing us to present our side of the payable through share draft issue.

Sincerely,

Margaret N. Rectanus/by Mary Dunn

Margaret N. Rectanus
Vice President

QUESTIONS/ANSWERS

Q1. Your written testimony states, "CUNA never anticipated that its support for passage of the Expedited Funds Availability Act would jeopardize the national payable through draft system." Why do you believe that the Federal Reserve's proposed regulation of payable through drafts, which was rejected in court, would have this effect? If the proposed amendment affecting payable through drafts were enacted, how do you believe it would disadvantage credit unions? Do you believe that many businesses would stop accepting payable through drafts if they were considered nonlocal? Do you have any hard evidence to support your views?

A. The Federal Reserve Board's Regulation CC as originally proposed required that credit union payable through share drafts be treated as local or nonlocal, depending on the location of the payable through bank. This would have meant that a credit union payable through share draft would be local only if the bank to which the item was presented was located in the same Federal Reserve check processing region as the payable through bank. Most credit unions using payable through share drafts utilize Chase Manhattan Bank or one of four banks endorsed by Traveler's Express in Minnesota. Therefore, most payable through share drafts would have been nonlocal and subject to slower availability than local items.

Because most payable through share drafts would be nonlocal items, CUNA was concerned that many merchants would be reluctant to accept the drafts. Also, CUNA was fearful that merchants would not distinguish between payable through share drafts and other share drafts and would thus discriminate against all credit union share drafts.

We were also concerned that if credit unions feared merchants and others might not accept their items because they are payable through, such credit unions would feel obliged to leave the national payable through system and look for a local processor. (It would be out of the question for many credit unions to process their own items, as they simply do not have the people or financial resources to do so.) In many cases, the local processor would be a bank. This situation would have been extremely disadvantageous to a credit unions, for competitive reasons. Also, if the bank were the only local processor, it could have forced the credit union to pay high fees for its services and credit union members would have paid more for their share draft services. In addition, most bank processors are not able to offer truncation services, so credit unions would have been required to forego a technologically advanced system in order to assure acceptability of their items.

Fortunately, the U.S. District Court for the District of Columbia understood that the Board's initial proposal jeopardized the national payable through system. Thus, the Board was required to change Regulation CC before it took effect September 1, 1988. Because the rule was changed prior to its effective date, credit unions were not forced to look to local banks for processing. Also, banks were not given the opportunity to treat all payable through share drafts as nonlocal items and thus, there are no incidents we know of in which merchants refused to accept payable through share drafts as a result of Regulation CC.

Q2. Your testimony noted that the Federal Reserve initially proposed this amendment to the Act prior to its adoption of two changes to Regulation CC: a conspicuous labelling requirement and a provision shifting risk due to slow check returns to the credit unions. Do these changes render the amendment unnecessary? How will the labelling help depository institutions comply with the Act?

A. We believe that the changes to Regulation CC do render the legislative amendment unnecessary. Further, we find it illogical that the Board would be urging the payable through amendment now, before the regulatory amendments have had a chance to work. The amendment regarding shifting the risk of the loss to the credit union took effect February 1, 1990, and the other amendment regarding conspicuous labelling does not take effect until February 1, 1991.

CUNA is not certain to what extent conspicuous labelling will help depository institutions comply with the Act. To the degree that institutions provide availability on the basis of whether an item is local or nonlocal, the conspicuous labelling will assist institutions in categorizing payable through share drafts via manual inspection.

However, according to a study conducted by the Bank Administration Institute after Regulation CC went into effect entitled, **Regulation CC: Policy Types Implemented by Banks Nationwide**, the vast majority of banks do not provide availability based on whether an item is local or nonlocal but rather, they provide next day or immediate availability on check deposits. In the Federal Reserve Board's October 1989 **Report to Congress Under the Expedited Funds Availability Act: Deposits at Nonproprietary Automated Teller Machines**, the Board notes that "most banks have policies to provide same-day or next-day availability on all deposits and most banks surveyed for this report that have such policies have experienced minimal or no fraud losses to date."

Q3. Your testimony recommended that conspicuous labelling requirements be applied to all checks. How would this help customers determine the status of their checks? What are the costs of your proposal?

A. We feel that the real benefit of conspicuous labelling falls to consumers whose banks differentiate between local and nonlocal items. Consumers receiving payable through share drafts beginning in February 1, 1991 will not have to rely on a confusing MICR line but may use the four digit routing number to determine if the item is local or nonlocal. As we stated in our testimony, we feel that if all financial institutions are required to relabel their items, it will be much easier for consumers to tell quickly if an item is local or nonlocal. If an adequate transition period were provided so that checks were relabelled in the normal course of reprinting, virtually the only cost would be for the modified plates from which the checks are printed.

Q4. Testimony of the Federal Reserve states that reliance on the routing number is the only automated means available to determine whether a check is local or nonlocal. Thus, payable through drafts must be inspected manually, a time-consuming process. What is your reaction?

A. The Federal Reserve Board maintains that banks have difficulty in assigning availability under the Act for payable through share drafts since they cannot use the MICR line for that purpose in an automaced environment.

However, the Board acknowledges that all payable through checks handled by banks total no more than 2-3 percent of all checks written every year. Furthermore, the Board recognizes that only those banks that have different availability schedules for local and nonlocal items under the Act would have an interest in this operational issue.

We believe this issue has a de minimis scope as less than 15 percent of all financial institutions do not provide next-day or immediate availability on check deposits. Additionally, the average amount of payable through share drafts is less than $100, thus requiring many of these items to be given next-day availability under the $100 rule.

In the few banks that do impose holds, nonlocal holds are imposed on consumer accounts and not generally on merchant accounts, to which most share drafts are deposited. The Board has acknowledged that checks written by consumers are written predominantly to business and government payees. Further, the American Bankers Association has stated that business accounts are generally not subject to holds. The availability schedule for business deposits (known as "calculated availability") almost always ranges from zero to three days. Accordingly, funds for payable through share drafts deposited into business accounts are made available in time frames that are often more prompt than the local temporary availability schedules of the Act. Since payable through share drafts deposited into consumer accounts are comparatively rare, it follows that the number of payable through share drafts the banks have to identify as local or nonlocal are probably equally rare.

Further, the majority of consumer deposits are made at staffed teller locations. Hold determinations are generally made by tellers when the deposit is made by visually examining the face of the item. The Act necessitates the visual examination of the face of the deposited items in order for the bank to provide depositors with any notice of case-by-case or exception holds as well as to identify some next-day items.

The Federal Reserve Board has asserted that the Court's interpretation of the Act will expose some banks to the "potential risk of additional losses." While the Board is not clear about the components of this speculative exposure, CUNA assumes that they are: a) potential claims by depositors against banks for incorrectly identifying a local payable through share draft as nonlocal, and b) potential additional losses by those few banks that make funds available for local items under the maximum local schedule in the Act prior to learning that the items have been returned. The concern about the potential claims from depositors is adequately addressed by the conspicuous labelling. The concern about potential increased exposure due to delayed returns of payable through share drafts is addressed by shifting the risk of loss to the credit union.

Q5. Testimony of the Federal Reserve states that its amendment is consistent with the scheme of the Act to allow longer holds on checks that must be sent to nonlocal banks for collection. What is your reaction?

A. Under the Act, local checks are subject to shorter holds than nonlocal checks because of the shorter time it takes for local checks to be cleared and returned. Currently, the time required for payable through share drafts to be cleared and returned is at least as fast as many checks treated as local. This supports the local treatment specified under the Act.

The truncation and the electronic presentment procedures of the share draft system make it possible to clear and return payable through share drafts as fast as almost all local items. In the event this does not happen, the newly adopted regulation to require shifting the risk of loss to the credit union on which the item is drawn, affords the depositary bank substantial protection from any loss.

Another consideration that supports local treatment of payable through share drafts is the availability of local dispute resolution. If, for some reason, the depositary institution is unable to charge the return share draft back against the depositor, collection proceedings can normally be accomplished at the local level since the credit union is a local institution and the drawer of the share draft is normally a local resident.

In dealing with availability schedules, Congress was concerned not only with geographical proximity but also with "transportation networks" that shortened times for the clearing and return of checks. (H.R. Rep. No. 261, 100th Congress, 1st Sess.) The payable through share draft system is already receiving some share drafts on an electronic basis through Federal Reserve Banks and correspondent banks, and it stands ready to receive and return all share drafts on an electronic basis. With electronic procedures, the clearing and returning of most checks and drafts can be almost instantaneous regardless of where the checks or drafts were deposited or cashed.

The payable through system is a modern technologically advanced system. The fact is, the credit union share draft system has already implemented many of the long term goals of the Act. It is the only payment system in the country that is in a position to participate immediately in full scale truncation and electronic clearinghouse projects of the kind Congress directed the Federal Reserve Board to consider requiring by regulation.

Consumers Union
Publisher of Consumer Reports

MICHELLE MEIER
COUNSEL FOR GOVERNMENT AFFAIRS
CONSUMERS UNION

Response to Questions from Senators Dixon and Bond to Michelle Meier, Consumers Union

Q1. Your testimony claims that customers often have little choice about using automatic teller machines (ATMs). It does not argue that customers have few choices between proprietary and noproprietary ATMs. Other testimony has argued that a consumer, who wants to avoid a check hold, should make a deposit with his or her own bank's ATM rather than with a nonproprietary ATM. What is your reaction?

A1. Some banks do not even own proprietary ATMs, but only give their customers access to non-proprietary ATMs. Consequently, consumers holding accounts at these institutions do not have the luxury of making the choice between depositing funds in a proprietary ATM versus a non-proprietary ATM.

Further, even if a bank owns proprietary ATMs and participates in a shared network, the bank's customer may still not have a real choice between using the proprietary versus non-proprietary ATM. This will depend on the location of the machines and the restrictions on the consumer's mobility. Presumably, the bank joined the network because its own proprietary machines were not as accessible to portions of its customer base as the non-proprietary machines available through the network. Overcoming these accessibility hurdles to using the proprietary ATMs will be most difficult for lower-income consumers, those who frequently need prompt access to their funds, because their mobility is often severely restricted.

Q2. Other testimony has argued that nonproprietary ATMs will either stop accepting deposits or start charging deposit fees unless the Expedited Funds Availability Act is amended. What is your reaction?

A2. Again, according to the FRB, most banks participating in ATM networks already provide immediate (or close-to-immediate) access to funds deposited in the non-proprietary ATMs. Because the law does not require them to make any modifications at all to their current operating procedures, there is no realistic threat that these banks will stop accepting deposits or charge new fees for these deposits.

Of course, many banks already charge their customers for deposits into non-proprietary ATMs. (See attachments A and B.) Even if a network implements operational changes to comply with the permanent schedule in the check hold law, we do not anticipate that banks will have any reason to increase these fees because these operational changes should not involve significant costs.

Q3. Testimony from the banking industry advocates extending the definition of "new account" from 1 month to 6 months because most fraud losses occur in new accounts within the first six months. What is your view of this proposed amendment?

A3. We have not seen any data to indicate that "most fraud losses occur in new accounts within the first six months." Furthermore, the Massachusetts check hold law tracks the federal law in defining "new account" as one opened within the past 30 days. According to officials from the Massachusetts Division of Banks, that state law has not produced any significant increase in bad check losses during the five years it has been in effect.

Q4. What is your view on the dispute between the Federal Reserve and the credit unions over payable through drafts?

A4. We do not have a position on this issue at this time.

Q5. The Federal Reserve's testimony states that if these amendments are not passed, there will be a significant increase in fraud losses at depository institutions. Is it not reasonable to take preventive steps before the losses become so significant that the Board could suspend the availability schedules for certain classes of checks?

A5. We rejected the Federal Reserve's doom and gloom forecast regarding the risk associated with the check hold law when we supported the law's passage almost three years ago. The continuing positive reports about the successful implementation of the Massachusetts law, which tracks the federal law in many respects but provides even shorter hold periods for some classes of checks, only strengthens our view that the federal law, as it was originally enacted, does not present an unreasonable risk of loss to the industry. The federal law already incorporates adequate preventive steps to deter against unreasonable losses.

Q6. What is your view of the Federal Reserve's proposed judicial review amendment to the Act?

A6. Our understanding is that the amendment would only affect consumers to the extent they wished to challenge regulations issued by the Board under the Act. With this premise, we find the amendment troubling for the following reasons:

1) The amendment only gives "any party" the right to obtain judicial review. Persons unable to participate in the rulemaking proceeding would probably be unable to obtain judicial review, even if the rules were a clearly invalid

implementation of the law, since they would not be considered "parties." This is a very inappropriate restriction on judicial review in light of the fact that the law is intended to benefit each and every consumer. Any consumer that can establish that he has been injured by a regulation should have standing to obtain judicial review.

There are an assortment of reasons why consumers may not participate in an informal rulemaking process. They may not even know about the rulemaking, since notice is not provided individually. Rather, notice is only provided through the Federal Register, an esoteric publication that very few consumers read. Even if they know about the rulemaking, consumers may not have the resources or the time to participate in it during the limited time period during which comments are normally accepted. (In an adjudicatory proceeding, parties have the right to request a continuance to accommodate their resource and time limitations. No such procedure is available in the context of informal rulemaking.

Finally, preserving each injured consumer's right to obtain direct judicial review of the invalid regulation itself is extemely important here because the law gives banks a safe harbor from liability if they, in good faith, follow the implementing regulations issued by the FRB. 1987 Act section 611(e). Consequently, a consumer injured by a bank failing to follow the law but adhering to an invalid regulation may have no recourse against the bank. His best recourse would probably be a suit against the Board to invalidate the regulation. (This also raises questions about the appropriateness of limiting judicial review to the courts of appeals. If a consumer brought suit against a bank in district court for failing to comply with the law, would that court be without jurisdiction to review the validity of a regulation with which the bank complied, even if that review bore on the question of the bank's good faith reliance on the regulation?)

2) Even if an individual consumer or consumer organization had participated in the rulemaking proceeding, this amendment would only allow judicial review if a petition seeking review were filed within 30 days after the rule becomes final. This, too, is an inappropriate restriction on the right to judicial review because 30 days is an extremely short time period. Rarely would a consumer organization learn that the rule has become final, digest the content of the rule, secure the advice of counsel on the merits of a lawsuit, and actually file the lawsuit within 30 days.

Q7. Testimony from the Federal Reserve contends that most checks would not be received by the institution of first deposit by the

time that funds must be made available under the permanent schedule and that fraud may consequently increase. What is your reaction?

A7. First, the FRB's contention that most checks would not be received by the receiving institutions within the permanent hold schedule only applies to local checks. (The agency's testimony indicates that "almost three-quarters of nonlocal checks in the survey were returned to the institution of first deposit by the day funds must be made available for withdrawal under the permanent availability schedule. . ." page 6).

Second, the FRB's contention regarding local checks only applies to checks cleared through the FRB rather than local clearinghouses. (The agency's testimony indicates that "it may be possible to return many checks that are exchanged directly through local clearinghouse arrangements within (the permanent availability schedule.")

Third, the FRB's contention regarding the failure of most local checks to return within the permanent schedule is only marginally relevant. This is because the law does not require banks to release more than $100 in cash against a local check within the time frames set forth in the permanent availability schedule.

To explain this, we must separately discuss the time periods by which banks must release cash drawn against a local deposit and the time periods by which they must pay third party checks written against a local deposit. In the case of third party checks, the bank has until midnight of the day following its presentment to determine whether to honor the check. Consequently, a bank does not have to decide whether to pay third party checks written against the local deposit "within the permanent availability schedule." For example, assume that a local check were deposited on Monday. The permanent availability schedule requires making the funds available on Wednesday. However, if a third party check drawn against the account were presented on that day (Wednesday), the bank would have until Thursday at mid-night to decide whether to pay on the check. Consequently, the relevant statistic is not the percentage of checks that return within the maximum availability schedule (Wednesday). The relevant statistic, which the FRB has not presented, is the percentage of checks that return by midnight on Thursday.

In the case of cash withdrawals against a local check, the law does not require the receiving depository institution to allow the customer to make more than a $100 cash withdrawal against the local check by the day specified in the permanent availability schedule, i.e., the second business day after deposit. The bank can prohibit further cash withdrawals until 5:00 p.m. on the second calendar day, which is technically the third business day, at which time the bank is only required to release $400 additional dollars in cash.

The bank is only required to make the balance of the funds available at the start of business hours on the third business day following deposit, i.e., one full day beyond the date set forth in the permanent availability schedule.

Consequently, the FRB's contention that local checks are not returned within the time frames set forth under the permanent availability schedule only illustrates that consumers may withdraw up to $100 before it is probable that a returned check is received by the institution into which the check is deposited. Given the small dollar amount involved, and the low risk that a deposited check will be returned anyway, this contention does not raise significant concerns.

Finally, the Massachusetts check hold law sets hold periods that are shorter than anticipated return times for several categories of checks. For example, it sets a 2 day hold schedule for all checks deposited into banks located in Massachusetts if they are drawn on institutions locate anywhere in the New England region. (Under the federal law many of these checks would be classified as "non-local.") This successful law shows that hold periods can be shorter than the anticipated return times for most checks within a category without creating unreasonable losses.

Q8. The Federal Reserve also testified that the Act provides greater incentives for depository institutions to consider customers' creditworthiness before allowing them to open accounts and will increase costs to consumers. Are these potential adverse effects of the Act?

A8. Because we do not believe that the law poses increased risk, we do not believe that the law will force banks to alter their current procedures for assessing the creditworthiness of their customers. Further, we are not aware that banks altered these procedures in response to the many state check hold laws on which the federal law was modelled.

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19 March 1990

The Honorable Alan Dixon, Chairman
The Honorable Christopher S. Bond, Ranking Member
Senate Subcommittee On Consumer and Regulatory Affairs
U.S. Senate

RE: Expedited Funds Availability Act

Dear Senators Dixon and Bond:

Enclosed are answers to your questions following the March 1, 1990 hearing on the Expedited Funds Availability Act.

We appreciate your interest in our views. Please let us know if you or your staff have additional questions.

Sincerely,

Edmund Mierzwinski

Edmund Mierzwinski
Consumer Lobbyist

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ANSWERS OF U.S. PIRG CONCERNING THE EXPEDITED FUNDS AVAILABILITY ACT HEARING OF 1 MARCH 1990

1. Other testimony has argued that nonproprietary automatic teller machines (ATMs) will either stop accepting deposits or start charging deposit fees unless the act is amended. What is your reaction?

U.S. PIRG's testimony reflects our position that the act was intended to balance risks against the urgent consumer need to obtain rapid availability of deposited funds. Long negotiations were carried out prior to final passage and numerous industry requests were agreed to, resulting in a detailed regulation that accomplishes its goals.

The FRB's report on these deposits clearly stated, as indicated in our testimony, that banks are already providing rapid availability of funds deposited in **nonproprietary** and proprietary ATMs. Why should this change?

Again, we believe that the Federal Reserve Board (FRB) and the industry must look at software improvements or changes to the check crediting system rather than the new hardware described.

Subject to additional check, fees for all types of ATM transactions, especially for the use of nonproprietary or foreign ATMs, appear to be increasing dramatically, anyway, before the permanent schedule's implementation and not the fault of the act.

Instead of changing the law, perhaps it would be useful for the committee to request a General Accounting Office or Office of Technology Assessment review of both cost trends and ATM network technology issues.

2. Testimony from the banking industry advocates extending the definition of "new account" from 1 month to 6 months because most fraud losses occur in new accounts within the first six months. What is your view of this proposed amendment to the Expedited Funds Availability Act?

The industry argument is based on banker perceptions of the problem, but there is no fact-based record to back up the industry's position. Conversely, a representative of the Massachusetts Banking Division has recently told us that industry hasn't suggested the 30-day new account period is in need of change, nor claimed fraud loss increases due to it.

The Massachusetts checkhold law took effect over five years ago, requiring the same 30-day new account hold as the federal law. The Massachusetts experience is probably the longest that is useful to compare: no change appears to be needed.

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3. The FRB's testimony states that if these amendments are not passed, there will be a significant increase in fraud losses at depository institutions. Is it not reasonable to take preventive steps before the losses become so significant that the board could suspend the availability schedules for certain classes of checks?

Again, industry and agency testimony refers to their inability to describe a pattern of fraud resulting from the act's implementation under the temporary schedule.

Their position is that things will get worse when the permanent schedule goes into effect, because holds will be shorter. As discussed in our testimony, this assumes holds correlate to fraud. The industry has not proven this point to our satisfaction, especially for the classes of checks to be subject to additional holds under the amendments.

A further assumption is made: that the shorter hold periods of the permanent schedule will make any prudence impossible and subject the institution to the risk of loss of an entire deposited check. A comparison of return times to the permanent schedule availability requirements suggests that this is not the case. The act's limits ($100 on the 2nd day for local checks; with an additional $400 available on the third day at 5pm) on cash withdrawals from deposited checks, make any risk very small, especially when that exposure is balanced against the small number of returned uncollectible checks.

4. What is your view of the Federal Reserve's proposed judicial review amendment to the act?

We would like to comment on this amendment later in the week, if possible. We are concerned, but haven't reviewed it yet.

5. The FRB testified that the act provides greater incentives for depository institutions to consider customers' creditworthiness before allowing them to open accounts and will increase costs to consumers. Are these potential adverse effects of the Act?

We don't think such costs exist. If such costs did exist and could be attributed to the act, and not to other factors, such as the economy and the number of people employed and unemployed, for example, then those costs would need to be weighed against the benefits of the act. For example, the act's shortening of checkholds placed large sums into consumer pockets. The FRB has not analyzed the extent of this benefit.

It is always prudent for a business to assess its exposure and make a business decision on what services to offer to what buyers. Before the act was considered or passed, many banks used reporting services to see whether a potential customer had previously bounced checks or defrauded institutions. To assert

those costs are attributable to the act would be incorrect.

We have not seen evidence that institutions plan to increase this scrutiny in response to the act.

6. With respect to the proposed amendment extending hold periods for non-proprietary ATMs, you recommend that the committee employ a sunset provision which essentially would allow the permanent schedule to become effective after a date certain. What time frame do you recommend? Can any of the proposals studied by the Federal Reserve be developed so that they are cost effective within this time period? Are you aware of any proposed solutions to the shared ATM problem?

First, our testimony clearly opposes this amendment. That position remains unchanged. The sunset proposal was made only because we are concerned that if the committee chooses to support this amendment, that its action continue to reflect the legislative intent of the Act.

The act's language on this matter is technology-forcing. We are disappointed that the industry, while it has been able, in some networks, to figure out ways to make large numbers of non-proprietary deposits each month, has been unable to offer a good solution to this problem. We believe the industry should have done a better job of exploring ways of improving the crediting and verification of deposits from the nonproprietary bank to the consumer's bank.

Therefore, while have no special insights into solutions, we would urge the committee to put the industry on a deadline, if the committee chooses to recede to the industry position. Certainly, a two year deadline would be the maximum acceptable. Continued special reports to Congress on ATMs should be required of the FRB.

There are advances being made in this industry on a daily basis, many driven by the act's requirements. The FRB's reports have commented at length on its new return and other requirements, consequent to the act, which have dramatically shortened return times.

Also, new technologies are being developed all the time. Last week's *New York Times* (Sunday March 11, page F9) described a new check imaging technology. Use of such a system, or others, may provide a better solution than the industry's new, but slower to use and more expensive, ATMs.

THE WRITTEN STATEMENT OF

THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA

ON

EXPEDITED FUNDS AVAILABILITY ACT
BEFORE THE SENATE BANKING SUBCOMMITTEE
ON CONSUMER AND REGULATORY AFFAIRS
MARCH 1, 1990

The Independent Bankers Association of America (IBAA) offers these comments for the March 1, 1990, hearing record on the topic of the Expedited Funds Availability Act (EFAA). The IBAA is the only national trade association that exclusively represents this nation's community banks.

Before we comment directly on the EFAA, we would like to acknowledge and thank Chairman Dixon for proposing to examine regulatory burden in the near future. We understand that EFAA in fact will be a part of this discussion. The IBAA has made the reduction of regulatory burden a priority issue for community banks. The following is an excerpt from our 1990 trade association resolution on the regulatory burden:

> Excessive and unnecessary paperwork and compliance requirements are imposing such a severe burden on community banks that it threatens their very survival. Complex laws and regulations are made applicable to all sizes of depository institutions without regard to the source of the problem or the respective institutions' ability to comply. Congress and the regulators have failed to recognize that more often than not the problems they are attempting to rectify are unique to large institutions. This has often resulted in the drafting of unreasonable, burdensome regulations which are unfairly imposed on the small community banks of America.
>
> Many burdensome regulations recently have been adopted under the rationale of consumer protection, with no understanding or concern for the costs of compliance. Oftentimes, the cure is worse than the perceived disease. Complicated new regulations not only result in lowering standards of service for consumers, but they also lead to higher prices. This is particularly problematic for small community banks, as the cost for compliance accounts for a much higher percentage of their expenses than for larger banks, which have significant economies of scale advantages in this area. . .
>
> IBAA is committed to educating Congress and the regulators about the deleterious effect that the increasing paperwork and compliance burden is having on the profits and survivability of community financial insitutions.

We hope that you will take note of the differences between large and small banks, particularly in light of the too big to fail policy in this country. The theory behind most of the consumer legislation being passed is that the banks are public utilities. This theory does not differentiate between large banks and thousands of community banks.

We recognize that large financial institutions have not been allowed to fail, but community banks have been treated differently; operating outside of the "public utility" support system and under

the discipline of the free market system, we have been allowed to fail. Community banks face a very different competitive and regulatory environment than large banks. Community banks are paying their fair share in the face of the savings and loan debacle through increased premium levels which the money center banks are avoiding by funding themselves largely with foreign deposits and other non-deposit liabilities which are not assessed. Community banks exist to serve local communities, while money center banks serve nationwide and international markets. We ask you to keep these differences in mind as you consider these issues.

Our comments now turn to the EFAA which was enacted on August 10, 1987, and the resulting regulation, Regulation CC, which became effective on September 1, 1988. Its purpose was to make funds from deposited checks available to customers within specified schedules and to improve the check processing system. Prior to this, the IBAA testified on the proposed EFAA before the Senate Banking, Housing & Urban Affairs Committee in January 1987. We explained to the Committee that most of our members provided immediate availability in most cases. This is particularly true for local, payroll, U.S. government or any check deposited into an established rather than a new account. Moreover, a great many of our members are small and serve small rural communities. Because of this, they tend to know who their customers are and when they don't, they are more cautious and vigilant against the possibility of crime. We argued against mandatory schedules because it would penalize those banks in which there was no problem. Many times our banks found that certain holds were the primary deterrent to writing fraudulent checks or to drawing checks on too few funds.

However, concerns about the sins of the few won out over the deeds of the many, and EFAA was enacted as a section of the Competitive Equality Banking Act of 1987 and set the stage for one of the biggest compliance nightmares since Truth-in-Lending for financial institutions. Regulation CC itself was 600 double-spaced pages. Slowly, banks tried to sort through this massive new regulatory burden. Seminars were held by regulators and trade associations; new staff had to be hired to analyze the new regulations for the institutions that had to implement them; certain policy and operations changes had to be made; numerous new disclosures had to be issued; and other similar processes had to be executed in order to understand the new law.

Now that 18 months have transpired since enactment and the permanent schedules are about to become effective, it is appropriate to try to assess EFAA's impact. Cost to the institutions is a major component of this assessment. Several different groups have tried to measure cost, but more time must elapse before a truly fair assessment of cost can be made. It is, however, helpful to examine the data collected by various groups on cost of compliance and impact of the changes in the first year and one half.

In September 1989, a consortium of 20 state community bankers associations hired Young and Associates to study the cost of compliance by their members with various new regulations. For banks with approximately $50 million in assets, the cost of compliance

with EFAA was approximately $2,863. For the smaller banks in general, the costs of compliance tended to be higher than for slightly larger ones (see appendix for further details). A study of Kansas bankers showed that they spent an average of $700,000 implementing Regulation CC (source: "Expedited Funds Availability Act: Was It Worth the Cost?," by Dave Fettig, December 1989; The Region). According to the Federal Reserve Board's June 1989 "Report to Congress Under the Expedited Funds Availability Act," the most costly aspect of the law was in employee training and printing and mailing of the disclosure statements to the customer. No institution was exempt from this part of the EFAA.

An additional question to be asked when assessing the impact of the EFAA is how it affected financial institutions overall and how the consumer was affected. The Young and Associates study showed that 44% of those member banks had already been meeting the availability requirements; 42% were meeting most of the requirements; and 2.7% had to make extensive changes. About 45% of the banks surveyed by Young and Associates had to make some kind of alteration in policies and practice to comply with the new Act.

The Federal Reserve Board also did several surveys concerning EFAA and found that 75% or more institutions provide their customers with same day or next day availability and do not even impose holds as long as those permitted by the Act. The institutions (only 10%) place blanket holds, according to the schedules imposed by the Act, on their customers' deposits because they perceive a higher risk of fraud loss from making funds available before having an opportunity to learn whether deposited checks are being returned. The Federal Reserve Board did find that some bankers (30%) actually lengthened the holds they place on deposits in response to the Act. These bankers believed that if they disclosed very prompt availability policies, they would be subject to greater fraud possibilities. Virtually all banks had to make some changes in policy, even if they were minor, according to the Federal Reserve. The Kansas Bankers Association study indicated that 93% of the banks in Kansas had same day or next day availability before the Act and it fell to 85% post EFAA. In the first few months after enactment, even the Senate Banking Subcommittee on Consumer and Regulatory Affairs received complaints from consumers whose "checkholds" had been lengthened. The Act may have eliminated the blatant offenders but it also worsened the situation for consumers in many other cases.

In general, consumer reaction to this law has been bland. In 1989, the American Banker newspaper did a survey of consumer reaction to EFAA. This showed that the impact on consumers was minor. In fact, only 53% of the consumers polled were aware that their financial institution had a formal "checkhold" policy. The Federal government can mandate disclosure to its heart's content, but it cannot mandate that the consumer read it.

Governor Wayne Angell, before the Subcommittee on Consumer and Regulatory Affairs on March 1, 1990, testified that the Federal Reserve has made changes to expedite the collection of checks and the return of unpaid checks. This was another goal of the EFAA. These changes have speeded up the process, but as Governor Angell

stated, the cost to institutions has increased at least in the short run.

The IBAA does not have exact fraud figures for checks before and after EFAA. It is very difficult to separate fraud from collectibility. Different banks report losses in separate categories and others lump all sorts of losses together. Taking this into account, we have found that some banks have reported a higher loss rate since EFAA was passed. We fear that this will be compounded when the permanent availability schedules are in effect. Uncollectible checks under the permanent schedules could often not be returned within the shortened periods of time. An institution would have to release its funds before it might know that something is uncollectible. Savvy individuals could easily exploit this system.

The fraud problem is exacerbated by the definition under the Act of new account. A new account is one that has been open for 30 days. After that, it must be treated as an established account. 30 days could not possibly be long enough for an institution to realize that the account holder is not honorable. Accounts that have been open for less than 6 months are more likely to be candidates for abuse.

Although we do not have firm statistics yet on fraud after EFAA, we have reasonable expectations of different kinds of fraud occuring. We would like to offer the following amendments which would alleviate some of the fraud concerns and other problems. These amendments are supported by the Federal Reserve Board and other industry groups to lessen some of the risk and burden of this already burdensome law.

1) The first amendment would permit a financial institution to apply the exceptions for large deposits (over $5000), redeposited checks, and repeated overdrafts to government and depository checks. Further, this amendment would allow the institution the discretion to release only the first $5000 on the next day.

As passed in EFAA, the institution must release all funds from government and depository checks on the next day after deposit under any circumstances. Since IBAA banks report that most of their fraud losses occur with government and depository checks, it does not make sense to bar this exception from this class of checks. Once depositors become familiar with the provisions of the law, the possibilities for fraud and forgery will go up. Incidently, this amendment was originally in the House- and Senate-passed versions of EFAA but was deleted in conference. This amendment was then passed in the Proxmire Financial Services Modernization Act of 1988, but was never signed into law.

2) The second amendment would allow institutions to provide one-time notices when funds will be held beyond statutory schedules. Under the law, whenever an exception is used, the institution must notify the customer of the hold. This does not make sense, especially in the case of the repeated overdraft exception. It would be more efficient and result in less paperwork for the institution to provide a one-time notice describing the circumstances under which these exceptions could be invoked, or when

the holds are being used. This amendment was also passed as part of the Proxmire bill.

3) The third amendment would allow the temporary availability schedule to be made the permanent one for deposits made at non-proprietary ATMs. When EFAA was enacted, it was expected that technology would be available by the permanent schedule enactment date to distinguish between classes of checks deposited at non-proprietary ATMs. However, this is not the case. Stephen S. Cole of the Electronic Funds Transfer Association, when questioned on March 1, 1990 before your subcommittee, said that a very limited and very costly alternative IBM ATM is available for purchase at a cost of $70,000 per unit. Otherwise, distinguishing between checks before sending them to the account-holding institution would have to be done manually. Either way, it increases the cost and slows down the process. Michelle Meier, representing the Consumers Union, argued that this could be accomplished through electronic means and alteration of procedures. The fact remains that this technology has not fully been developed. We respectfully suggest that the temporary and more reasonable schedules remain in effect until such time as technology is developed. Small rural banks could not comply without great risk of fraud or at a great cost and/or inconvenience with the permanent schedules. The IBAA does not wish to see banks stop shared ATMs from accepting deposits because of fear of non-compliance with EFAA or fear of fraud loss.

4) The fourth amendment has been discussed to some extent previously in this statement. We suggest that the definition of "new account" be lengthened from 30 days to 6 months.

5) The fifth amendment requires that in the case of credit union share drafts, the payable through bank should determine the local or nonlocal status of the draft, not the location of the credit union itself. This provision was originally passed in EFAA but the Credit Union National Association was able to obtain a reversal in a U.S. District Court. We are now asking to reverse it again.

This problem is a matter of equity. The only way that a financial institution can determine by computer if the draft is local or non-local is through its routing number. This number only indicates the location of the payable through bank. Determination of hold status in these cases would have to be performed manually. The amendment allows for longer holds on checks that must be sent to nonlocal banks for collection. Complying with this without the amendment is very difficult for community banks.

6) The sixth amendment requires government checks deposited into proprietary ATMs to be treated the same as deposits of cash and other checks that receive next day availability. The rule is that they must be deposited at staffed facilities for immediate availability. Non-staffed facilities should allow a slightly longer hold time.

Attached to the testimony in the appendix is legislative language suggested for these technical amendments.

The IBAA stands ready to work with the subcommittee on these issues and would be glad to answer any questions or provide further information.

APPENDICES

ATTACHMENT I

Community Bank Regulatory Compliance Study: Survey Summary - September 1989

Overview

Community bankers face an ever-increasing array of regulatory requirements. Also, in addition to the growth in regulations affecting traditional banking functions, the past few years have seen the emergence of regulations requiring banks to perform duties that are not directly related to the course of their normal banking activities (such as Bank Secrecy Act requirements, tax withholding requirements, etc.). As a result, concern is growing with respect to the cost to community banks of complying with the myriad of regulations. There is also much anecdotal evidence to suggest that community bankers perceive that many regulations have a disproportionate impact on smaller banks and that the concerns of the community bank are not being addressed in the development of new regulations.

However, no wide-scale study of community bank compliance practices and costs has been performed, nor have community bankers' opinions regarding the current regulatory environment been quantitatively assessed. Therefore, a consortium comprised of 20 state community bankers associations decided to undertake research to investigate these areas. Young & Associates, Inc., was engaged to conduct this research.

The research is being done in two phases. The first phase, completed during the summer of 1989, was a mail survey of members of the sponsoring organizations. The second phase, scheduled to begin in October, 1989, will be an in-depth tracking study of compliance costs. *The purpose of this report is to summarize the objectives, procedure, and findings of the mail survey.*

Objectives

The objectives of this survey were:

- To determine how community banks manage their compliance function with respect to personnel, training, and budgeting/cost analysis.
- To obtain community bankers' opinions and perceptions regarding various aspects of compliance.

- To determine the costs of complying with selected regulations.
- To compile the recent examination experiences of community banks.

With respect to the third objective, it is important to understand how "costs" are being defined for the purpose of this study. In this portion of the research, *only direct non-labor costs were requested from participants.*

The regulations chosen for this survey were Regulation CC (all aspects), the changes in adjustable-rate mortgage disclosure requirements under Regulation Z that went into effect October 1, 1988, the IRS requirement under the Interest Dividend and Tax Compliance Act that banks provide tax identification number (TIN) certification for customers with interest-bearing accounts, and the currency transactions reporting requirements of the Bank Secrecy Act.

Procedure

The consensus in initial discussions with the research sponsors was that it would be important to survey as many community banks as possible. Therefore, the universe selected for the survey was the combined membership of the sponsoring associations.[1]

To enhance the probability of a good response, it was decided to have the associations forward the survey questionnaire to their members. A total of 4,403 questionnaires were then mailed to the banks by the associations between approximately May 30, 1989 and July 5, 1989.

Completed questionnaires were received from the first week in June of 1989 through August 31, 1989. In that period of total of 1,171 questionnaires were received, of which 1,152 were usable. Based on usable questionnaires, this yielded an overall response rate of 26.2%.

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1. The exception to this was South Dakota, which did not include its entire membership.

Results[2]

Respondent Bank Characteristics

Table I

Size of Respondent Banks

Assets (in 000,000's)	Percent*
< $25	37.4
$25 - $49	26.8
$50 - $99	22.5
$100 - $199	9.0
$200 +	4.4
Mean: $60.7 million	
Median: $34.3 million	
Range: $1.4 million - $1,121 million	

Most (67.7%) respondent banks had state charters, and the national banks tended to be somewhat larger (mean assets of $74.5 million) than their state-charted counterparts (mean assets of $51.1 million).

Management of Compliance - Structure

Respondents were asked if their bank had an officer with "specific responsibility for overseeing the compliance function," to which 93.7% answered in the affirmative. Of these, 97.7% listed only one officer. Regarding officer responsibilities, 97.9% indicated that the compliance officer had other duties in addition to compliance, and more than half of these indicated the other responsibilities were in the lending area.

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2. PLEASE NOTE: Although the total number of usable responses received in the survey was 1,152, many of the analyses reported here were based on a lesser number of responses. The reasons are that not all questions applied to all respondents, many respondents left some questions blank, and some responses were illegible. Unless otherwise noted, the percentages reported for a particular analysis are based on the number of responses to the question on which that analysis is based, not on the total number of responses to the survey.

Respondents were also asked what percentage of the compliance officer's time was devoted to compliance. 60.9% reported that the compliance officer spent less than 20% of his/her time on compliance. An additional 21.0% reported that the officer spent between 20% and 29% of his/her time on compliance. As bank size increased, the percentage of banks that reported an officer with specific responsibility for compliance increased. Similarly, the larger the bank, the more time the compliance officer spent on compliance.

Next, respondents were asked, "Do you have a management or board committee that oversees compliance?" 38.2% responded that there was a committee. Of those with a committee who responded, 49.1% indicated that the committee was comprised solely of officers, and 26.1% reported the committee include both officers and directors. Also, as bank size increased, there was a significantly greater likelihood of having a compliance committee.

Management of Compliance - Training

Table II

Compliance Training Methods Used

Method	*Percent Using*
Schools/Seminar Series	47.0
Individual Seminars	71.8
Regulator Publications	81.0
Trade & Commercial Publications	64.5
Videotapes	32.7
Consultants	13.7
Other	11.3

Management of Compliance - Expense Tracking

Respondents were asked, "Do you have a separate category in your expense budget for compliance?" 97.9% responded that they did not. However, when asked to provide an estimate of 1988 compliance expenses, 64.6% were able to do so. The mean estimate was $6,968 and the median was $2,000. Banks over $200 million were significantly more likely to have compliance in their expense budget.

Respondents were then asked if they attempted to analyze the cost of existing banking regulations and proposed or forthcoming regulatory changes. Over 80% said they attempted no analysis of the cost of existing regulations, while 73.4% said they did not try to analyze the costs of proposed regulations. When asked why no analysis was attempted, the responses were primarily that it would either be of no use or irrelevant (e.g., "it won't change anything") or be too difficult, expensive, and/or time consuming.

Opinions about Compliance

Respondents were asked to indicate their degree of agreement with each of a series of statements addressing various aspects of compliance and banking regulations. These results were as follows:

- Recent regulations seem to focus on more on trivial or relatively unimportant issues than did previous regulation.

  Strongly Agree/Agree - 78.2% Disagree/Strongly Disagree - 14.3%

- The bank regulatory agencies generally understand the problems facing community banks.

  Strongly Agree/Agree - 27.2% Disagree/Strongly Disagree - 67.1%

- As our bank has become more adept at managing compliance, we have found it less difficult to comply with each new regulation.

  Strongly Agree/Agree - 39.9% Disagree/Strongly Disagree - 49.9%

- The compliance requirements being placed on banks are greater than they were 10 years ago.

  Strongly Agree/Agree - 95.9% Disagree/Strongly Disagree - 1.8%

- Compliance is more of a problem for large regional banks and money center banks than it is for community banks.

  Strongly Agree/Agree - 11.5% Disagree/Strongly Disagree - 77.2%

- The procedures for complying with most regulations are unnecessarily time consuming.

  Strongly Agree/Agree - 81.4% Disagree/Strongly Disagree - 12.2%

Compliance Survey Summary

- Most recent regulation has been necessary to correct abuses by those in the banking industry.

  Strongly Agree/Agree - 30.8% Disagree/Strongly Disagree - 55.8%

- Community banks should be regulated differently than larger banks.

  Strongly Agree/Agree - 68.2% Disagree/Strongly Disagree - 20.9%

- Compliance may sometimes be a problem, but in general most existing regulations are good for the banking industry.

  Strongly Agree/Agree - 46.2% Disagree/Strongly Disagree - 43.6%

- In general, compliance places an unfair burden on our bank.

  Strongly Agree/Agree - 69.1% Disagree/Strongly Disagree - 19.8%

- The people drafting regulations do not consider the impact that the regulations will have on community banks.

  Strongly Agree/Agree - 89.3% Disagree/Strongly Disagree - 5.1%

- Consumers generally come out ahead because of banking regulations.

  Strongly Agree/Agree - 31.4% Disagree/Strongly Disagree - 61.8%

Respondents were then asked, "If you could do away with any one banking regulation, which one would it be." This question was followed up with the question, "If you could do away with any two regulations, what would your second choice be?"

Table III

Regulations Respondents Would Eliminate (1st & 2nd Choices Combined)

Regulation	*Percent**
Regulation Z (Truth in Lending)	34.1
Regulation CC (Expedited Funds Availability)	32.1
Regulation BB (Community Reinvestment)	14.4
Bank Secrecy Act	12.7
Regulation X (R.E. Settlement Procedures)	7.6
Regulation C (Home Mortgage Disclosure)	5.2
Regulation B (Equal Credit Opportunity)	5.2
TIN Certification/Reporting	4.0
All others	26.3
None	3.0

Beyond just knowing which regulations respondents would choose to eliminate, it is important to determine *why* the respondents made those particular choices. As an overall observation, the comments indicated that most of the respondents had no problems with the *intent* of the regulations (except for the currency transactions reporting requirements of the Bank Secrecy ACT and TIN certification/tax reporting, which they generally thought should not be bank responsibilities). Rather, the comments focused on the applicability of the regulations to most community banks, the basic utility of some of the regulations as they are currently structured (particularly Regulations Z and X) and the difficulties, relative to the benefits, of fulfilling the requirements of the regulations.

Costs of Compliance - Regulation CC

Respondents were first asked if their banks had to make changes to meet availability requirements that went into effect in September of 1988. 44.9% indicated they were already meeting all requirements prior to the regulation going into effect, and another 42.5% indicated that they were already meeting most requirements and had to make only a few changes. Only 2.7% reported having to make extensive changes. Also, banks under $50 million were more likely than other banks to have already been meeting all availability requirements.

Next, respondents were asked to indicate how much their banks had spent on each of several expense items related to Regulation CC. The average total expense was $2,863.

When the sum of the Regulation CC costs were broken down by asset group, it was found that smaller banks had disproportionately higher expenses.

Table IV
Regulation CC Expenses by Assets

Assets (000,000's)	*Mean CC Expense*	*Mean Assets*	*Multiple**
< $25	$2,137	$19.3	110.7
$25 - $49	$2,783	$37.3	74.6
$50 - $99	$3,593	$71.3	50.4
$100 - $199	$4,018	$132.2	30.4
$200 +	$7,984	$353.9	22.6

*Mean Regulation CC expenses divided by mean assets (in 000,000's).

Costs of Compliance - Regulation Z (10/88 ARM Disclosures)

Respondents were asked if their banks had to make changes to meet the disclosure requirements under Regulation Z that went into effect October 1, 1988. More than half (55.5%) indicated the changes did not apply to their banks as they did not offer adjustable-rate mortgages. Of the remainder, 12.6% had to make no changes, 38.0% reported they were already providing most disclosures, but had to make a few changes, and 28.4% had to develop complete disclosures.

Respondents were then asked to record how much their banks had spent complying with the changes in Regulation Z. The average total expense was $1,694.

As with Regulation CC, it was found that smaller banks also had disproportionately higher Regulation Z expenses. Here, the effect was even greater than it had been for Regulation CC.

Table V

Regulation Z (ARM Disclosures) Expenses by Assets

Assets (000,000's)	*Mean Z Expense*	*Mean Assets*	*Multiple**
< $25	$1,439	$19.3	74.6
$25 - $49	$1,604	$37.3	43.0
$50 - $99	$1,672	$71.3	23.5
$100 - $199	$1,925	$132.2	14.6
$200 +	$2,992	$353.9	8.5

*Mean Regulation Z expenses divided by mean assets (in 000,000's).

Costs of Compliance - TIN Certification

Respondents were asked to record how much their banks had spent on certifying tax identification numbers in the past year. The average total TIN expense was $1,578.

When the sum of the TIN costs were broken down by asset group, the general pattern was that smaller banks had disproportionately higher expenses, though not as severely as with the Regulation CC and Regulation Z.

Table VI
TIN Certification Expenses by Assets

Assets (000,000's)	Mean TIN Expense	Mean Assets	Multiple*
< $25	$778	$19.3	40.3
$25 - $49	$1,309	$37.3	35.1
$50 - $99	$1,438	$71.3	20.2
$100 - $199	$5,468	$132.2	41.4
$200 +	$5,570	$353.9	15.8

*Mean TIN certification expenses divided by mean assets (in 000,000's).

Costs of Compliance - Bank Secrecy Act (Currency Transactions Reporting)

Respondents were asked how much their banks had spent during the past year complying with the currency transaction reporting requirements of the Bank Secrecy Act. The average total expense was $703.

As opposed to the previous regulations examined, the ratio of Bank Secrecy Act expenses to bank size remains relatively stable throughout the range of asset categories. Put another way, all banks (at least in the range of asset sizes included in this survey) seem, on a percentage basis, to be bearing approximately equal Bank Secrecy Act expense loads.

Table VII
Bank Secrecy Act Expenses by Assets

Assets (000,000's)	Mean BSA Expense	Mean Assets	Multiple*
< $25	$262	$19.3	13.6
$25 - $49	$517	$37.3	13.9
$50 - $99	$849	$71.3	11.9
$100 - $199	$1,607	$132.2	12.2
$200 +	$4,233	$353.9	12.0

*Mean Bank Secrecy Act expenses divided by mean assets (in 000,000's).

Costs of Compliance - Summary

To try to ascertain the accuracy of the total compliance expense estimates covered in the Management of Compliance section, the sum of the mean expenses for the four individual regulations were compared to the mean total estimates.

Table VIII

Sum of Regulation Expenses vs. Total Estimated Expenses

Assets (000,000's)	*Sum of Reg. Exp.*	*Mean Est. Exp.*
< $25	$4,616	$3,103
$25 - $49	$6,213	$5,176
$50 - $99	$7,552	$8,595
$100 - $199	$13,010	$10,158
$200 +	$20,779	$39,257

As Table VIII indicates, for three of the five asset categories used in this research, the sum of the mean expenses for the four regulations *exceeds* the mean estimates of total compliance expenses for those categories. In addition, for the $50 million - $99 million category the sum of the four regulations is nearly 88% of the mean estimate.

As it is unlikely that these four regulations alone represent all (or nearly all) compliance expenses, it evident that many banks, particularly smaller banks, may be severely underestimating their total expenses. The reason is that it would be very unusual, given the multitude of other regulations with which banks must comply, for just these four areas to consume the overall compliance expense.

Recent Examination Experiences

Respondents were asked when they had their last compliance examination. 47.3% reported having an exam in the previous 12 months, and an additional 21.1% indicated an exam had occurred in the previous 24 months. Of the respondents who reported having an exam within the past 12 or 24 months, the FDIC was cited by 58.8% as having performed the exam. OCC was mentioned by 20.8%, and the Federal Reserve Board by 10.7%. Also, state banks were much more likely to have been examined within the past 12 or 24 months (77.8% vs. 48.2% for national banks).

When asked what the examiners had found in their banks, 20.2% reported the examiners had no concerns, while 66.0% reported problems concerns with real estate or other loan practices and/or documentation, and 8.2% mentioned community reinvestment.

Participating State Associations

Independent Bankers of Colorado

Connecticut Community Bankers

Community Bankers of Florida

Community Bankers Association of Georgia

Community Bankers Association of Illinois

Community Bankers Association of Indiana

Kansas Independent Bankers Association, Inc.

Independent Community Bankers Association of Kentucky, Inc.

Louisiana Independent Association of Banks

Michigan Association of Community Bankers

Independent Bankers of Minnesota

Missouri Independent Bankers Association

Nebraska Independent Bankers Association

Independent Bankers Association of New York State

Independent Community Banks of North Dakota

Community Bankers Association of Ohio

Community Bankers Association of Oklahoma

Independent Bankers of Pennsylvania

Independent Community Bankers of South Dakota

Independent Bankers Association of Texas

Virginia Association of Community Banks

Association Coordinator: C. Scott Williams, Community Bankers Association of Ohio

REGULATION CC:

Its Effects on Kansas Banks

By Jackie Dinkel

[Editor's Note: Regulation CC and the Expedited Funds Availability Act have created a tremendous compliance burden on Kansas banks. The following study, researched and written by KBA staff member Jackie Dinkel, explores the history and requirements of Reg. CC as well as the effects Reg. CC has had on Kansas banks.

Dinkel serves as legal assistant in the KBA Compliance, Legal and Litigation Center. She recently received a bachelor's degree in business administration from Washburn University and also holds an associate of arts in legal assistance from Washburn. She will begin attending the Washburn University School of Law in August.

Dinkel would like to acknowledge the assistance of KBA staff member Ann McMorris who helped with the statistical information. Dinkel's study was completed for the Washburn School of Business Honors program and was presented at the Bank Management Clinic in Lawrence last month.]

THE Expedited Funds Availability Act (EFA) was enacted on Aug. 10, 1987, as Title VI of the Competitive Equality Banking Act. Regulation CC (12 CFR Part 229) was adopted by the board of governors of the Federal Reserve System on May 11, 1988 to implement the EFA, and its requirements became effective Sept. 1, 1988.

Reg. CC requires depositary institutions to make funds deposited into transaction accounts available according to specified times established in a temporary schedule effective Sept 1, 1988.[1] A permanent schedule becomes effective on Sept. 1, 1990. Reg. CC also requires depositary institutions to pay interest on interest-bearing transaction accounts no later than the day credit is received.[2] Additionally, depositary institutions are required to disclose funds availability policies to their customers. Reg. CC also establishes rules designed to speed the collection and return of unpaid checks.[3]

Check Collection

Prior to Reg. CC, banks imposed holds because of the risks in allowing a customer to withdraw funds from deposits that have not yet been collected from the paying bank.[9] Most checks are returned by the paying bank because of insufficient funds in the drawer's account.[10] If the depositary bank has allowed its customer to draw checks against the deposit before it receives notice that the check is insufficient, an overdraft may be created in the customer's account.[11] The bank's customer is liable to the bank for the overdraft. However, the bank may not be able to collect from an insolvent customer or drawer. Checks are also returned for forgeries and stop payments. There are also kiting schemes where the depositor plays two accounts against each other, often resulting in a loss to at least one bank. To reduce these risks, banks have placed holds on deposits long enough to assure that checks have not been dishonored.[12]

Additionally, banks imposed holds due to the slow check return process. Under the check collection system, a depositary bank sends a check that has been deposited in its bank to the paying bank to be paid. The depositary bank never hears a word if the check is paid.[4] Only if the check is dishonored by the paying bank will the check be returned or the depositary bank be notified.[5] Because of this slow return process prior to Reg. CC, it could take as long as 20 days for a depositary bank to receive word of a dishonor.[6] Although less than 1 percent of all checks were returned,[7] many banks imposed holds on all checks to protect themselves against returns. Furthermore, many banks extended the holds to the latest possible date upon which they learned of the return.[8]

Prior to the EFA and Reg. CC, there was no law requiring banks to send back returned items in an expeditious manner. Article 4 of the Uniform Commercial Code (UCC) had been the primary source of check. Under the UCC, Section 4-104 requires the paying bank to either pay or return the check by midnight of the next banking day following the banking day on which the paying bank receives the item. Because the UCC contains no duty of expeditious return, paying banks often sent their returns by mail rather than courier even though a courier leaving after midnight would result in a faster return.[14]

The UCC also encouraged banks to return items along the same path they were sent for payment rather than directly to the depositary bank. It takes an average of 1.6 days to send an item for payment; however, it takes an average of 5.2 days to return an item.[15] The return process was costly, and the items were handled by hand because they were not MICR-encoded.[16] Additionally, there were no indorsement standards under the UCC, therefore, many indorsements placed on the item on its way to be paid slowed down the return process.

Regulation J regulates items collected through the Fed, but basically mirrors Article 4 of the UCC. Reg. J does, however, require the paying bank to send notice of dishonor to the depositary bank on checks of $2,500 or more. As stated earlier, Reg. J only deals with checks collected through the Fed, and more than half of all checks are not collected through the Fed.[17]

Finally, the UCC gave further approval of long check holds in § 4-213(4)(a) and § 4-103. Section 4-213(4)(a) provides that funds become available to the customer only after "the bank has had a reasonable time to learn that the settlement is final." Section 4-103 allows the bank and the customer to determine what a reasonable hold is, and courts upheld long check holds in light of the slow return process.[18]

Emergence of Reg. CC

Holds placed on funds deposited by checks can create the following problem. Typically, a person de-

posits a check, waits a few days, and then writes several checks to pay some bills—only to have those checks returned as unpayable because of "uncollected funds."[19] The person immediately calls the bank to find out why the checks have bounced and is told that the check deposited to cover those amounts (sometimes a paycheck or a social security check) has not yet cleared.[20] Often the depositor is shocked to discover the bank routinely takes a week to clear a check drawn on a bank located in the same state and two weeks to clear a check drawn on an out-of-state bank.[21] Then, the person has to suffer the embarrassment of explaining the problem to the merchants and reissuing new checks, after waiting the required amount of time.[22] Finally, to add injury to insult, the person receives notices from both the bank and the merchants that there will be penalty charges for the bounced checks.[23]

other factors that would indicate there was little risk that the bank could be stuck with a bad check.[26] Any further hold beyond the time a bank itself received credit for a check deposit (usually one to three days) meant the bank was making money market rates on the customer's deposit, while the customer was denied the use of his or her money.[27]

In 1984, the Federal Home Loan Bank Board, the Federal Deposit Insurance Corp., the Office of the Comptroller of the Currency and the Federal Reserve Board issued a joint policy statement requesting financial institutions to refrain from imposing unnecessary delays in making funds available to their depositors.[28] The agencies hoped the problem, which had promulgated legislation in two states and proposed legislation in the U.S. Congress, could be handled by voluntary action of financial institutions.[29] Apparently the Senate Banking Committee didn't believe volun-

"...92.69 percent of Kansas banks offered either same day or next day availability, some with reasonable exceptions. Therefore, Kansas banks were legally forced to spend $733,505 to implement Reg. CC..."

This situation was brought to the attention of the Committee on Banking, Housing, and Urban Affairs in the U.S. Senate. The Subcommittee on Consumer Affairs held the first hearing concerning holds on customer check deposits in 1982.

Surveys conducted by the University of Michigan's Survey Research Center on behalf of the Federal Reserve found that 12 percent of consumers with checking accounts experienced problems with check holds in 1977; 20 percent experienced problems in 1981; 11 percent in 1983; and 15 percent in 1985.[24] Based on the number of families with checking accounts, those percentages translate roughly into between 5.5 million and 12 million families who have experienced problems with check holds.[25]

Concerns were voiced about some institutions that across-the-board were denying customers the use of funds far beyond the time it took for the bank to receive credit for the check, without regard to the size of the check, the quality of the relationship with the customer, or any

tary efforts were adequate because, after several years of study and hearings before that committee, the Expedited Funds Availability Act was included as Title VI of the Competitive Equality Banking Act of 1987.[30] It was passed on Aug. 10, 1987 and became effective Sept. 1, 1988.

Reg. CC Requirements

Every bank, savings bank, savings and loan association, and credit union with transaction accounts is affected by the Expedited Funds Availability Act and Reg. CC.[31] Transaction accounts are checking accounts, NOW accounts, and share draft accounts. Reg. CC (12 CFR Part 229) required that depositary institutions do the following by Sept. 1, 1988:

- ★ Comply with availability schedules
- ★ Comply with disclosure requirements
- ★ Comply with changes in the processing of checks
- ★ Comply with other requirements of the law

To comply with the availability schedules, banks were required to make customer deposits available for withdrawal no later than the times prescribed by law. The temporary schedule requires:

- ★ Next day availability for cash, cashier's checks, checks drawn on your bank, and federal, state and local government checks.
- ★ Funds from local checks must be available no later than the third business day following the day of deposit. A local check is defined as a check deposited in a depositary bank located in the same Federal Reserve check-processing region as the paying bank.
- ★ Non-local checks must be available for withdrawal no later than the seventh business day following the day of deposit. A non-local check is a check deposited in a different check-processing region than the paying bank.
- ★ The first $100 of a day's total deposits of local and non-local checks must be available on the first business day following the day of deposit.
- ★ Availability may exceed the maximum hold periods for the following exceptions: new accounts, frequent overdrafters, high-dollar deposits, redeposited checks, reasonable cause to doubt collectibility, and emergency conditions. Other than new accounts, availability may exceed the schedule by four days, but the exceptions do not apply to checks or other deposits subject to next day availability.

Beginning Sept. 1, 1990, funds availability policies must comply with the permanent schedule, which is the same as the temporary schedule with the following exceptions:

- ★ Availability for local checks moves from the third to the second business day after deposit.
- ★ Availability for non-local checks moves from the seventh to the fifth business day after deposit.

To comply with the disclosure requirements, depositary institutions were required to:

- ★ Give a disclosure of their funds availability policy to all existing customers, any new account customers, and any person who requests it. Disclosures to existing account holders were required to be mailed between Sept. 1 and Oct. 31 of 1988.
- ★ Post a notice summarizing their availability policy in the lobby of all their branches.

- ★ Post or provide a notice at each ATM that is owned or operated by the bank or for the bank.
- ★ Include a notice on all preprinted deposit slips.
- ★ Give a notice when availability is delayed. For example, a bank's policy may be to provide immediate or next day availability, but the bank retains the right to place a hold on a deposit from time to time or longer than the schedule based on an allowable exception.

To comply with the changes in the processing of checks, depositary institutions were required to:

- ★ Endorse checks with the routing number of their bank in the appropriate location in purple or black ink.
- ★ Expeditiously return checks they do not pay to the bank of first deposit.
- ★ Provide notice of nonpayment on all checks over $2,500 that are not being paid.

To comply with the other requirements of the law, depositary institutions were required to:

- ★ Begin accruing interest or dividends on deposits in an interest-bearing transaction account not later than the business day credit is received.
- ★ Limit holds on other funds a transaction-account customer has on deposit (including funds in savings accounts) to the time periods specified in the regulation when checks are cashed or accepted for deposit into an account.
- ★ Train their employees and furnish a copy of procedures to them.

Depositary institutions may be liable for damages for failing to comply with the availability schedules or disclosure requirements even if there are no actual damages to the customer.[32] There are no penalties for honest errors; however, there is a potential for damages of up to the lesser of $500,000 or 1 percent of net worth.[33]

Funds Availability Policies in Kansas

In January of 1989, the Kansas Bankers Association mailed a questionnaire to its 581 member banks requesting information regarding Reg. CC. A total of 348 banks responded to this questionnaire for a 60 percent response.

Approximately 342 banks responded to the questions regarding the funds availability policies they had in place prior to Reg. CC and following implementation of Reg. CC.

The top eight funds availability policies in place **prior** to Reg. CC were:

Same Day Availability with Case-by-Case Holds . . . 21.93%
Same Day Availability . . . 16.67%
Next Day Availability with Case-by-Case Holds . . . 14.33%
Next Day Availability . . . 8.19%
Case-by-Case Availability 4.39%
Same Day Availability with Exception Holds 4.09%
Same Day Availability with Case-by-Case, Exception, and New Account Holds 3.80%
Same Day Availability with Case-by-Case and New Account Holds 3.80%
and New Account Holds 7.02%
Next Day Availability . . . 6.73%
Same Day Availability with Case-by-Case and New Account Holds 5.56%
Case-by-Case 4.09%

Approximately 30.39 percent of the responding banks had funds availability policies which varied from those listed above. However, another 7.01 percent offered some variation of same day availability for a total of 35.09 percent still making funds available basically on the same day of deposit. In addition, another 12.85 percent offered some variation of next day availability other than those listed above for a total of 50.29 percent of Kansas banks making funds available the day after deposit. Therefore, even after implementation of Reg. CC, 85.38 percent of Kansas banks still offered either same day or next day availability and only 14.62 percent made funds available at a later time.

"It is ironic to note that a law intended to give customers earlier access to their funds has instead given customers in Kansas later access to their funds. Fortunately this did not occur to a great extent because of scrupulous Kansas bankers!"

Nearly 22.81 percent of the responding banks had funds availability policies which varied from those listed above. However, another 8.77 percent offered some variation of same day availability resulting in a total of 59.06 percent of Kansas banks making funds available basically on the same day of deposit. Another 11.11 percent offered some variation of next day availability other than those listed above for a total of 33.63 percent of Kansas banks making funds available basically on the day after deposit. Therefore, prior to Reg. CC, 92.69 percent of Kansas banks offered either same day or next day availability while only 7.31 percent made funds available at a later time.

Following implementation of Reg. CC, the top eight funds availability policies were as follows:

Next Day Availability with Case-by-Case Holds . . . 16.67%
Same Day Availability with Case-by-Case Holds . . . 14.33%
Same Day Availability . . . 8.19%
Next Day Availability with Case-by-Case and New Account Holds 7.02%
Next Day Availability with Case-by-Case, Exception,

The following information shows how many banks actually changed their funds availability policies due to the implementation of Reg. CC:

- ★ 52.05 percent retained the same funds availability policy after Reg. CC that they maintained prior to Reg. CC.
- ★ 20.18 percent retained the same funds availability policy after Reg. CC that they maintained prior to Reg. CC with only one or two changes, such as adding case-by-case, exception, or new account holds to their original policy.
- ★ 12.28 percent basically changed their funds availability policy from same day availability to next day availability.
- ★ 15.49 percent either made major changes to their funds availability policy or didn't fit in any other category.

In April of 1989, KBA mailed an additional questionnaire to Kansas banks requesting further information on their specific hold policies prior

(Continued on pg. 16, col. 1)

REGULATION CC:

(Continued from pg. 8)

to the implementation of Reg. CC. One hundred fifty-nine Kansas banks responded to this questionnaire with the following results:

Approximately 92.69 percent of Kansas banks offered same day or next day availability prior to Reg. CC, with holds only being placed for very specific reasons. The main reasons Kansas banks placed holds on deposits prior to Reg. CC were as follows:

New accounts
Doubted collectibility
Experienced problems with the account in the past
Suspected kiting
Uncollected funds
Checks returned insufficient previously
Prior problem with a check or maker
Account repeatedly overdrawn

The top six maximum amounts of time Kansas banks held funds prior to Reg. CC were as follows (29 percent of Kansas banks held funds for periods of time other than those listed below):

Ten Days—32%
Zero Days—12%
Five Days—9%
Seven Days—7%
Fourteen Days—7%
Three Days—4%

Prior to Reg. CC, 65 percent of the banks in Kansas paid interest on deposits placed in interest-bearing accounts at the time of the deposit, 25 percent of the banks paid interest at the time the bank received credit, 3 percent paid interest the next day, 7 percent paid interest at times based on other criteria, and only one bank began paying interest after a hold period had expired.

Prior to Reg. CC, when a hold was placed on a deposit, 54 percent of the banks invested funds before the time a hold had expired, 26 percent of the banks did not invest funds before the time a hold had expired, 11 percent did not have information available to answer, and 9 percent did not place holds on deposits. Many of the banks which responded that they did invest funds before the time a hold had expired advised that this amount would be very minimal. This is because only amounts above minimum required deposits by either their correspondent bank or the Federal Reserve could be invested.

For banks that had a specific hold policy prior to Reg. CC, 16 percent stated there were circumstances where the bank waived those holds, 15 percent stated there were not circumstances for which they would waive a hold, 18 percent did not have information available to answer this question, 42 percent of the banks said they did not have a specific hold policy, and 9 percent did not place holds on deposits.

Costs of Implementing Reg. CC

Banks have to follow many requirements to be in compliance with Reg. CC. Needless to say, all at additional costs to Kansas banks.

The 348 banks that responded to the questionnaire spent a total of $733,505 on disclosure, training, and operational costs to comply with Reg. CC requirements. Additional information on the amounts spent on each category follows:

* 312 banks spent $262,647 on disclosure.
* 278 banks spent $133,462 on training of employees. Additionally, for every employee a bank trained to implement Reg. CC, it cost an average of $41.71.
* 191 banks spent $241,105 on startup operational costs such as equipment.
* 150 banks spent $96,291 on annual operational costs.
* Therefore, the total spent on all operational costs, both startup and annual, was $337,396.
* 148 banks estimated future disclosure, training, and operational annual costs to be $151,032.

For a closer look at the costs Kansas banks incurred implementing Reg. CC, see the table on the next page. The table groups banks in eight different asset sizes and shows the number of banks responding in each asset size along with the average amounts incurred for disclosure, training, operational, and future costs.

Conclusions

Reg. CC was implemented because of institutions that were denying customers the use of their funds far beyond the time it took for a bank to receive credit for a deposit. How-

REDUCE YOUR LOSS RATIO

How often has your staff needed to locate a missing person? How often have they sent a file to an outside firm? How often has that person still not been found? How often was that firm very expensive?

Would you like to be able to increase your company's in-house find ratio, or decrease your company's expense of outside locating firms?

Financial Training Institute has the "How to Find Missing Persons" Manual, specifically designed to help anyone in a commercial environment, find missing persons on their own and increase the probability of collecting from a bad account. There are a variety of methods and concepts contained in our Manual that can significantly lower the costs of finding missing persons. This Manual also shows how to detect social security number fraud.

The "How to Find Missing Persons" Manual is comprehensive, yet easily understood, and has been found extremely valuable by two groups involved in locating or collection, the novice and the veteran. Some of the organizations that are benefiting from our Manual include:

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Credit Unions	International Corporations
Rental Agencies	Law Enforcement Personnel

Previous users of this Manual have found that most companies can recover their purchase price by resolving one specific past or future case. Users also find that the Manual increases their job skills enabling them to dramatically change their department's value to the company.

"The Nilson Report" (a credit card executive advisory service) recommended the original "How to Find Missing Persons" Manual to every business in issue No. 164, of July 1981.

The Manual is authored by Don Elliott. His background includes over 25 years of investigative experience as a Naval Intelligence Officer, Retail Credit Administrator, and Owner of Collection Agencies.

Wouldn't you like to improve your firm's probability of successful locating? To receive your copy of the "How to Find Missing Persons" Manual send $79.95 to:

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ever, this was not a practice in Kansas. It has been shown that approximately 92.69 percent of Kansas banks offered either same day or next day availability, some with reasonable exceptions. Therefore, Kansas banks were legally forced to spend $733,505 to implement Reg. CC; when, in fact, Kansas banks made funds available to their customers earlier than the new law required.

Furthermore, banks were criticized for placing holds on customers' deposits beyond the time the banks themselves received credit so that they could make money on their customers' deposits. Even though 54 percent of Kansas banks did invest funds if available, this amount was very minimal because again 92.69 percent of Kansas banks made funds available either the same day or the day after the date of deposit.

For example, Reg. CC allows a bank to hold a non-local check for seven days after the date of deposit. Therefore, a bank who offered next day availability prior to Reg. CC could have chosen to make funds available according to the maximum amount allowed by law after the implementation of Reg. CC. In that case, the bank who offered next day availability could now make a non-local check available for withdrawal six days later; therefore, the bank would have an additional six days to invest its customers' deposits for its own use. Kansas banks have chosen not to do this. It has been shown earlier that even after the implementation of Reg. CC, 85.38 percent of Kansas banks still offer either same day or next day availability.

It is ironic to note that a law intended to give customers earlier access to their funds has instead given customers in Kansas later access to their funds. Fortunately this did not occur to a great extent because of scrupulous Kansas bankers! Certainly, there must have been other options that could have been taken to monitor and prohibit only those banks which actually abused the use of their customers' deposits.

I believe a grave detriment has been forced upon the banks in Kansas. Additionally, I believe the American tax dollar has been wasted when no doubt other measures could have been taken to correct this problem. However, I do feel a great sense of pride working for such a conscientious group of bankers who choose to continue to make funds available to their customers as soon as possible even though legally they are not required to do so.

[1] Comptroller of the Currency, *Comptroller's Handbook for Consumer Examinations*, August 18, 1988, Temporary Insert, Section 215.1, p. 1.

[2] Mary P. Johannes and Barnett D'Amours Sivon & Shay, *A Banker's Guide to Expedited Funds Availability* (Rolling Meadows, 1988), p. 1.

[3] Comptroller of the Currency, p. 1.

[4] Barkley Clark and Barbara Clark, *Regulation CC: Funds Availability and Check Collection* (Boston, 1988), p. 1-2.

[5] Ibid., p. 1-2.

[6] Ibid., p. 1-3

[7] *United States Code Congressional and Administrative News: 100th Congress—First Session 1987* (St. Paul, 1987), II, 516.

[8] Clark and Clark, p. 1-3.

[9] Ibid., p. 1-1.

[10] Ibid., p. 1-1.

[11] Ibid., p. 1-2.

[12] Ibid., p. 1-2.

[13] Ibid., p. 1-3.

[14] Ibid., p. 1-4.

[15] Ibid., p. 1-4.

[16] Ibid., p. 1-4.

[17] Ibid., p. 1-4.

[18] Ibid., p. 1-5.

[19] *U.S. Code Congressional and Administrative News*, II, 515.

[20] Ibid., p. 515.

[21] Ibid., p. 516.

[22] Ibid., p. 516.

[23] Ibid., p. 516.

[24] Ibid., p. 516.

[25] Ibid., p. 516.

[26] U.S. Government Printing Office, *Hearing before the Subcommittee on Consumer Affairs of the Committee on Banking, Housing, and Urban Affairs, United States Senate*, Ninety-Seventh Congress, Second Session, March 10, 1982 (Washington, 1982), p. 1.

[27] Ibid., p. 1.

[28] Federal Financial Institutions Regulators, *News Release*, March 22, 1984.

[29] Federal Financial Institutions Regulators, attachment.

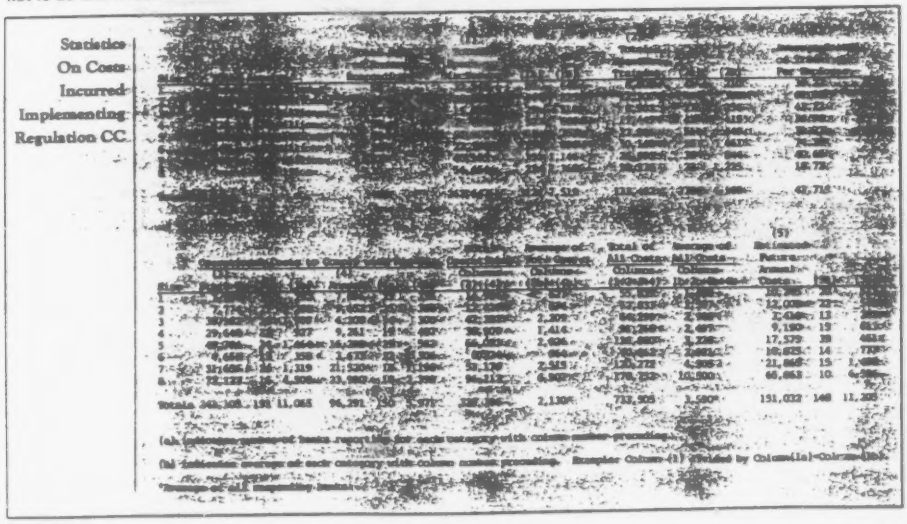
[30] Public Law 100-86, Title VI, Aug. 10, 1987, 101 Stat. 635, (H.R. 27).

[31] Board of Governors of the Federal Reserve System, Special Notice, "You are Affected by the Expedited Funds Availability Law," (June 1988), p. 11.

[32] Ibid., p. 10.

[33] Comptroller of the Currency, p. 15.

Statistics On Costs Incurred Implementing Regulation CC.



IBAA
INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Philip J. Vallandingham
President

David Ballweg
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O. Jay Tomson
Chairman

Kenneth A. Guenther
Executive Vice President

March 29, 1990

Honorable Alan J. Dixon
Chairman
Senate Banking Subcommitte on
Consumer and Regulatory Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510-6075

Honorable Christopher S. Bond
Ranking Minority Member
Senate Banking Subcommittee on
Consumer and Regulatory Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510-6075

Dear Chairman Dixon and Senator Bond:

The Independent Bankers Association of America (IBAA) is pleased to submit the following answers to your questions for the hearing record on the Expedited Funds Availability Act.

We look forward to working with you in the future.

Sincerely,

Kenneth G. Guenther
Executive Vice President

WASHINGTON OFFICE, ONE THOMAS CIRCLE NW, SUITE 950, WASHINGTON, D.C. 20005-5802 • 202 659-8111

Q1. Your testimony contends that measuring fraud losses is difficult because fraud and collectability problems cannot easily be separated. In support of your first amendment, your testimony alleges that the Independent Bankers Association of America (IBAA) banks report that most of their fraud losses occur with government and depository checks. Can you reconcile these two statements? If data on fraud losses is generally not available, on what basis do you make the second statement?

A1. In our testimony, we specifically state that the IBAA does not have exact fraud statistics before and after EFAA. While there is no supporting data, based on ongoing dialogue with our bankers, we have determined that government checks are our number one source of fraud. Also, based on a dialogue with our bankers, we have found that bankers have experienced more losses, in general, after implementation of EFAA.

Q2. Your testimony cites several figures which reflect the cost of compliance with Regulation CC. Your statement and the attached survey indicate that 1988 compliance costs averaged $2,863. Then, your statement refers to a study of Kansas bankers which indicates a total average cost of $700,000. Please explain the different components of the two studies. What costs are reflected in the Kansas study that are not reflected in the Young and Associates study?

A2. The Young and Associates study listed the average cost to a bank with a particular asset level -- $2,863 for a $50 million bank. $700,000 is an aggregate figure for the 348 banks participating in the Kansas study. For those banks with assets of $45 million, the average cost was $2,184. A typical IBAA member bank has an asset level of about $45 million.

Q3. What is your view of the Federal Reserve's proposed judicial review amendment to the Expedited Funds Availability Act?

A3. The IBAA has not taken a formal position on this amendment. However, it appears to make sense to streamline the review process and avoid duplication.

Q4. Will the proposed amendments which you endorse add to or subtract from the regulatory burden of the Act?

A4. The amendments that we have endorsed will subtract from the regulatory burden of EFAA by removing some of the obstacles to complying with the pending permanent schedules. For example, the deposits at proprietary ATMs amendment will allow banks to continue to comply with the funds availability schedules without hardship or undue cost. The credit union amendment negates the necessity for tedious and slow manual routing of share drafts. A one-time notice obviously cuts down on paperwork. The staffed facility requirements for availability schedules lessens the burden by reducing the possibility of fraud as does the exception amendment. These changes will not substantially reduce the already overwhelming paperwork burden our banks are experiencing under this Act, but they will help.

Statement of

Travelers Express Company, Inc.

submitted to the

Subcommittee on Consumer and Regulatory Affairs

of the

Committee on Banking, Housing and Urban Affairs

United States Senate

at the

Hearing on the Expedited Funds Availability Act

March 1, 1990

Summary

The Federal Reserve Board is proposing legislation which would cause payable-through share draft accounts to be treated less favorably than bank checking accounts and so would impede the credit unions' ability to compete. This proposal is the latest in a long history of changes that have already created a great deal of uncertainty for credit unions using the payable-through share draft system. Exactly the same issue already has been decided in court--in favor of the credit unions and against the position of the Board. We do not see any need for Congress to continue to devote its scarce resources to the issue.

Credit unions use the payable-through system so that they can provide share draft accounts to their members. The proposed legislation would hinder credit unions' ability to provide services to their members and would benefit the Federal Reserve Banks in their competition with private sector service providers. Proponents of the legislation have failed to show any evil that it would cure. Amendments at this time would be premature. For these reasons, the Subcommittee should reject the proposal.

Travelers Express Company is the largest processor of credit union payable-through share drafts. The centralized, technologically advanced clearing services which Travelers Express provides help credit unions provide to their members an alternative to the checking accounts offered by banks. Without payable-through clearing services, many small to medium size credit unions would not be able to provide share draft accounts to their members.

Background

The Board proposes to amend the Expedited Funds Availability Act ("EFA"), which is Title VI the Competitive Equality Banking Act of 1987[1]. The implementing Regulation CC took effect September 1, 1988[2].

As originally adopted, Regulation CC defined a credit union payable-through share draft as local or nonlocal depending on the location of the payable-through bank relative to the location of the institution in which the draft was deposited. Under the Act, a draft is local or nonlocal depending on the location of the "originating depository institution" relative to the location of the institution in which the draft is deposited. The "originating depository institution" is the credit union. The definition in the original Regulation was contrary to the Act.

The Credit Union National Association and one of its member credit unions brought suit against the Board to challenge the Regulation, and they

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[1]12 USC 4001-4010. The Act creates maximum time periods within which depository institutions must make funds deposited by check or draft available for withdrawal. The availability of funds depends on whether the check or draft is "local" or "nonlocal."

[2]12 CFR Part 229.

succeeded[3]. The court stated that "payable through banks are an efficient and cost effective method of collecting and processing share drafts" and decided that the Board's Regulation CC as it applied to payable-through share drafts was invalid.

> "To summarize, the court finds that the plaintiffs have made credible allegations of a threatened injury fairly traceable to Regulation CC as promulgated . . . The court further holds that Regulation CC as promulgated veers dramatically from the clear and unambiguous intent of Congress."

After a lengthy and thorough rule-making process, Regulation CC was amended to conform to the decision[4]. The Board now seeks to overturn this decision and this amended Regulation by legislation.

Proposed Legislation

The Act defines "originating depository institution" as, "the branch of a depository institution on which a check is drawn." The Board proposes to add, "or through or at which a check is payable, as prescribed by regulations of the Board." This change would make most payable-through share drafts nonlocal items. That would permit depository institutions to hold funds longer before making them available to the depositor when deposited by a credit union share draft than when deposited by a check drawn on a bank in the same community with the credit union.

Recommendations

The Subcommittee should reject the proposal for the following reasons:

(1) The court--and not the Board--correctly understood the Congressional intent. We believe that Congress intended that credit union payable-through share draft accounts should continue to be the equivalent of bank checking accounts.

(2) The issue has already been thoroughly debated, and amendments to Regulation CC have been adopted to address the issue. The amendments are not fully effective until February 1, 1991. The Board should not propose more changes until after that date.

(3) The issue has created a great deal of uncertainty for credit unions during the past three years. The Board should allow credit unions time to adjust to the recent amendments designed to address this issue before there are any further changes. One amendment requires credit unions to

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[3]700 F. Supp. 1152, 57 U.S.L.W. 2130 (United States District Court for the District of Columbia, July 28, 1988).

[4]53 FR 31290, August 18, 1988.

include additional information on their share drafts. Credit unions have already begun replacing their supplies to comply.

(4) The Federal Reserve Banks sell share draft processing services in competition with private sector providers. The Board's proposal would tend to benefit the Federal Reserve Banks at the expense of the private sector.

03-12-90
NJC\POSITION

USL
UNITED STATES LEAGUE of SAVINGS INSTITUTIONS
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J. DENIS O'TOOLE
Executive Vice President
for Government Affairs/Operations

March 12, 1990

The Honorable Alan J. Dixon, Chairman
Subcommittee on Consumer and Regulatory Affairs
Committee on Banking, Housing and Urban Affairs
U.S. Senate
Washington, DC 20510

Dear Mr. Chairman:

The U.S. League of Savings Institutions* requests that this letter be included in the record on the recent hearings to consider technical corrections to the Expedited Funds Availability Act and to recommend revisions to Regulation CC. The U.S. League appreciates the opportunity to present its views.

When Congress passed EFAA in 1987, it provided for a gradual reduction of check holds. A phase-in reduction of check holds was designed to enable the financial industry, the Federal Reserve System and other providers of check processing services and products time to prepare for the much shorter permanent hold schedule effective September 1, 1990. In addition, it was thought that during this phase-down period, there would be technological improvements to expedite the collection and return of checks. In turn, these improvements were expected to facilitate compliance with the much shorter check-hold schedule.

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*The U. S. League of Savings Institutions serves the more than 2,700 member institutions which make up the $1.3 trillion savings association and savings bank businesses. League membership includes all types of institutions -- federal and state-chartered, stock and mutual. The principal officers include: Kenneth D. Seaton, Chairman, Hancock, Michigan; Robert O'Brien, Vice Chairman, Morristown, New Jersey; Fred Webber, President, Washington, D.C.; J. Denis O'Toole, Executive Vice President for Government Affairs; and Rex Yoshida Grohl, Senior Vice President for Regulatory Affairs. League headquarters are at 1709 New York Avenue, N.W., Suite 801, Washington, D.C. 20006. Telephone: (202) 637-8900. The Chicago office is located at 111 East Wacker Drive, Chicago, Illinois 60601. Telephone: (312) 644-3100.

Unfortunately, this has not happened. At this time, man and technology has encountered barriers to moving checks faster. Without breakthroughs, financial institutions will have to release deposited funds before they can find out if a check is "good." This is especially true for local checks. Currently local checks are returned the morning of the day that deposited check funds must be made available for withdrawal. Under the permanent schedule, the situation changes dramatically. No local checks will be returned by the Federal Reserve before funds must become available.

A recent U.S. League survey illustrates that most local checks are returned late. Findings show that it takes the Federal Reserve more than two business days to return local checks, yet Reg CC compliance demands faster returns. Failure to meet the two-day return rule in Reg CC increases the risk of loss since holds will have already been released on deposited funds. Moreover, a Federal Reserve spokesperson confirmed our results. At a check processing seminar, this spokesperson said that most unpaid local checks are not being returned within the two-day time frame. As the predominant provider of return checks, the Federal Reserve System's inability to consistently meet this schedule endangers the safety and soundness of financial institutions.

We believe the Federal Reserve has diligently tried, during the last two years, to comply with the two-day return rule for local checks. Yet, it still has not happened. In our opinion, the return schedule is unachievable because it was based on an impractical check-hold schedule. We think that shorter check holds must be synchronized with a feasible check return schedule. But, this will not be the case under the permanent schedule.

The U.S. League recommends that the General Accounting Office immediately review the Federal Reserve System's ability to comply with Reg CC's two-day rule. If the GAO finds local returns are, indeed, returned late, we recommend that Congress delay the permanent funds availability schedule effective September 1, 1990 for an additional year.

If the permanent schedule is not postponed, the U.S. League recommends that the large deposit safeguard exception, Section 604(c)(3) of the Act, be lowered to $2,500 from $5,000 while limiting the extended hold on these deposits to a maximum of five business days for all checks. The advantages of a $2,500 nonaggregated cutoff are manyfold. The biggest benefit is that unpaid return notices for high-risk, large-dollar deposits are not received after the shortened check holds expire. Next, depositary banks "know thy customer" best and they are in a better position to make a business or credit decision when accepting large-dollar deposits. Third, setting the return notice amount equal to the safeguard ends the administrative burdens and paperwork cost associated with return notices (see Reg CC Section 229.33). Finally, litigation and disputes from late or incorrect notices stop.

The Federal Reserve System also benefits. The Fed can drop its costly and cumbersome notification service. By dropping this service, the Fed's risk of liability from failure to exercise reasonable care or provide timely delivery of notices ceases.

Customers will benefit too. First, not all large-dollar checks will be held under the "know thy customer" principle. Second, this approach only affects checks between $2,500 and $5,000 because extended holds already apply to

checks exceeding $5,000. Next, current holds can be extended up to 11 business days, while our proposal restricts holds to five business days. Finally, operating costs decrease by dropping an outdated notification requirement, which will reduce the cost of banking services to customers.

In addition, the U.S. League encourages Congress to consider these EFAA and Regulation CC amendments:

1. To limit next-day availability to $2,500 in Section 604(a)(3) of the Act on certified and similar checks as defined in Reg CC Section 229.10.

2. To modify the permanent availability schedule for shared ATM deposits in Section 603(e)(2)(A) of the Act so that all deposits into shared ATMs under the permanent schedule are treated as nonlocal items subject to a five-business-day hold as currently permitted for ATM deposits in the temporary schedule (see Section 229.11(d) of Reg CC).

3. To reduce the number of extended hold notices that depository institutions must furnish when accepting deposits (see Section 229.13(g) of Reg CC). We recommend an initial one-time disclosure for deposits in excess of $2,500 and redeposited checks and a single notice for each occurrence when the repeated overdraft safeguard is invoked.

4. To impose liability rules regarding losses and violations of the Board's check collection and return regulations on state and local governments on which checks are drawn (see Section 611(f) of the Act).

5. To specify that U.S. Treasury checks not deposited in person be available for withdrawal no later than the second business day after the banking day on which the funds are deposited (see Section 603(a)(2)(F)(i) of the Act).

6. To allow depository institutions to consider accounts opened for the first 90 days as new accounts (Section 604(a) of the Act) and reduce the maximum holds for deposits subject to Section 229.10(c)(1)(i) through (v) in excess of $2,500 to five business days.

The U.S. League appreciates the opportunity to suggest EFAA and Regulation CC amendments. We believe that our recommendations will enhance the effectiveness of Reg CC and minimize the safety and soundness risks inherent with the shorter check holds starting in September. If you have any questions, please contact me or O. Tom Thomas, Vice President for Operations and Technology.

Sincerely,

J. Denis O'Toole

J. Denis O'Toole

Board of Governors of the Federal Reserve System

Deposits at Nonproprietary Automated Teller Machines

Report to Congress
Pursuant to the Expedited Funds Availability Act

October 1989

REPORT TO CONGRESS UNDER THE EXPEDITED FUNDS AVAILABILITY ACT: DEPOSITS AT NONPROPRIETARY AUTOMATED TELLER MACHINES

I. PURPOSE OF THE REPORT

The Expedited Funds Availability Act ("the Act" -- Title VI of the Competitive Equality Banking Act of 1987 [12 USC 4001-4010]) directs the Board of Governors of the Federal Reserve System ("the Board") to establish and maintain a dialogue with banks[1/] and their suppliers on the computer software and hardware available for use in operating automated teller machines ("ATMs"). The Act also directs the Board to transmit a report to Congress one year after enactment (and each year thereafter through 1990) regarding software and hardware issues, and the potential for improving the processing of ATM deposits.[2/]

This is the Board's 1989 report to Congress on ATM issues. It examines the current processing environment for ATMs, the operational and systems impact of certain requirements of the Act on these systems, industry comments on the impact of the temporary availability schedule of Regulation CC on ATM systems, and the ability of ATM systems to provide information necessary for account-holding banks to comply with the permanent availability schedule established by the Act, which becomes

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1/ Regulation CC defines bank to include all depository institutions, including commercial banks, savings and loan associations, and credit unions.

2/ The first report on this subject was transmitted to Congress in October 1988.

effective September 1, 1990. The Board has discussed these issues with representatives of banks, ATM networks, trade associations, and equipment vendors in preparing this report.

II. BACKGROUND

Automated teller machines were first introduced in the United States in 1969 and originally functioned exclusively as a means of withdrawing cash from deposit accounts. ATM networks are either proprietary[3/] to one bank or shared[4/] by multiple banks.

In a proprietary ATM system, a bank purchases or leases ATMs, acquires the necessary software or develops it in-house, installs the system, and issues access cards to its customers. In this environment, the bank maintains complete control of the system and its services, and its product is identified with only one bank. Implementing and marketing a proprietary ATM network, however, is costly. Transaction volume is limited to that generated by the bank's cardholders, leading to high unit costs since the fixed costs of installing an ATM network are substantial.

3/ For the purposes of this report, a proprietary ATM network is owned and operated by one bank and is accessed by customers of that bank only. This definition does not reflect the location criteria contained in the Act or Regulation CC.

4/ A shared ATM network is one that provides access to the customers of multiple banks. A shared ATM is generally considered nonproprietary to the institutions that do not own and operate it.

In a shared ATM network, customers of one bank can access their accounts through ATMs owned or operated by other banks. This sharing of network facilities increases the potential volume at each ATM, allowing fixed costs to be spread over more units. Banks that participate in shared ATM networks forego sole decision-making control and the unique product identity gained through a proprietary system. Shared ATM network participants, however, are able to provide more convenient ATM services to customers without bearing the total cost of developing and operating a large ATM network. Shared ATM networks are either regional or national in scope.

Many shared ATM networks do not allow bank customers to make deposits. In networks surveyed for this report that accommodate deposits at nonproprietary[5/] ATMs, deposits represent a small percentage of the total transaction volume. The number and total dollar amount of deposit transactions at each network varies, however, depending on the size of and geographic location served by the network. For example, in one network, more than two million deposits are made at ATMs each month, with approximately one million made at nonproprietary ATMs.

5/ A nonproprietary ATM is defined in the Act as one that is not proprietary. In the Act, the term "proprietary ATM" means an automated teller machine which is (1) located at or adjacent to a branch of the receiving institution or in close proximity, as defined by the Board, or (2) owned by, operated exclusively for, or operated by the receiving depository institution. Also, refer to note 4 regarding shared ATMs.

The Act specifies the time periods within which funds deposited at ATMs must be made available for withdrawal. Different rules apply under the temporary schedule to deposits at nonproprietary ATMs than to deposits at proprietary ATMs, because of operational differences in the way these deposits are processed. In the case of deposits made at proprietary ATMs, the bank that owns or operates the ATM generally removes the deposit envelopes from the ATM, opens and verifies the contents of each envelope, performs the proof-of-deposit function, prepares the checks contained in the deposit for collection, and posts to the customer's account from the actual deposit. Generally, the account-holding bank has the ability to ascertain the composition of deposits made at proprietary ATMs and, thus, is able to apply differential holds and invoke the exceptions contained in the Act.

In contrast, deposits made at a nonproprietary ATM are removed and processed by the ATM operator, rather than the account-holding bank. The deposit envelopes are opened and verified, and the checks contained in the deposit are prepared for collection. An electronic message is forwarded to the customer's bank notifying it of the date, time, location, account number, and aggregate amount of the deposit, as keyed into the ATM by the customer. The customer's bank posts the deposit to the customer's account based on the information contained in the electronic message. In the event of a discrepancy between the

deposited amount entered by the customer and the actual amount of the deposit, as verified by the ATM operator, adjustment entries are transmitted by the ATM operator to the account-holding bank. In the case of nonproprietary ATM deposits, the account-holding bank cannot ascertain the composition of the deposit (i.e., whether the deposit consists of cash, checks generally subject to next-day availability, local checks or nonlocal checks) and therefore cannot apply differential holds or invoke any of the Act's exceptions.

During consideration of the Act, banks reported to Congress on processing limitations associated with accepting deposits at nonproprietary ATMs. It was stated at this time that the account-holding bank does not have the information necessary to place holds on nonproprietary ATM deposits. Given these limitations, the Act, in effect, allows the account-holding bank to treat any such deposits as though they were composed of nonlocal checks under the temporary availability schedule (i.e., funds must be made available not later than the seventh business day after deposit). Under the permanent schedule, however, deposits at nonproprietary ATMs generally must be made available for withdrawal within the same time periods as deposits made at staffed teller facilities. For example, local and nonlocal check deposits must be made available for withdrawal not later than the second and fifth business day following deposit, respectively. Deposits that otherwise would be subject to next-day availability

must be made available for withdrawal not later than the second business day following deposit. Congress anticipated that the processing limitations that necessitated the special availability rule for nonproprietary ATM deposits under the temporary schedule would be addressed by the time the permanent schedule becomes effective in September 1990. The House Conference Report on the Act stated " . . . the conferees believe it is reasonable to expect the owners and operators of such ATMs to develop the necessary technology to make such differentiations within a reasonably short time."[6/]

III. DISCUSSION

During the past year, the Board has explored with representatives of shared ATM networks and participating banks alternative approaches to comply with the permanent availability requirements for deposits made at nonproprietary ATMs. These alternatives include (1) implementing system changes in order to provide the account-holding bank with information concerning the composition of deposits by its customers at nonproprietary ATMs, so that availability can be provided accordingly; (2) adopting and disclosing a shortened availability policy for all deposits made at nonproprietary ATMs; and (3) eliminating the deposit function at nonproprietary ATMs.

6/ H.R. Conf. Rep. No. 261, 100th Cong., 1st Sess., 179 (1987).

Potential System Changes. Shared ATM networks and banks provided information about potential methods of processing nonproprietary ATM deposits so that the account-holding bank has sufficient information to apply differential holds to the components of the deposit in accordance with the permanent availability schedule. These methods include (1) requiring the customer to identify the necessary information at the time of deposit; (2) modifying the ATM to capture information concerning the composition of the deposit; (3) having the ATM operator capture information concerning the composition of the deposit when processing the deposit and transmit this information to the account-holding bank; (4) establishing a clearing agent for the network; and (5) having the ATM operator sort and deliver unopened deposit envelopes to the account-holding banks. These methods are discussed below.

Requiring the customer to identify the necessary information at the time of deposit. The ATM operator or network could require consumers to indicate the composition of the deposit at the time of the ATM transaction. This would require a change to ATM operating procedures to allow consumers to indicate the types and amounts of checks and the amount of cash included in the deposit. ATM network transaction formats would also have to be changed to accommodate the additional information, such as

the types of deposit and dollar amount of each deposit type. The ATM operator, account-holding bank, and network switch[7/] would incur costs to modify their processing systems to handle this additional information.

This method would make the account-holding bank totally dependent on the accuracy of information supplied by the consumer. Networks commented that this dependence on the consumer is not practical. They questioned whether consumers could be educated to identify accurately the various types of checks. The task of correctly identifying checks would be complicated because neither consumers nor account-holding banks can rely on the routing number encoded in the MICR line of the check to determine the availability of certain types of checks, such as payable through checks. Because bank payable through checks are encoded with the routing number of the payable through bank, rather than the bank on which they are written, account-holding banks cannot rely on the routing number encoded on the check to determine whether these checks are local or nonlocal and must refer to other information on the face of the check to determine availability. The account-holding bank is also unable to determine from the routing number the special

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7/ A network switch is the electronic mechanism that receives and transmits transaction messages between the bank that operates the ATM and the bank that holds the customer's account.

treatment that must be provided certain checks (e.g., cashier's, certified, and teller's checks, and state and local government checks) and, thus, this option would not facilitate the application of proper holds for these checks. In addition, if the ATM is not local to the account-holding bank, consumer confusion regarding proper availability is further increased. ATM network representatives also indicated that this method could lead to increased fraud if consumers learned that misidentifying the type of check being deposited would generate faster availability of funds.

In addition, under this alternative, the time it takes for a consumer to complete a deposit transaction at an ATM would be increased, due to the requirement that the consumer input details concerning the composition of the deposit. The increased amount of time to input the additional information could result in longer lines at ATMs, making them less convenient for customers.

Modify the ATM to capture information concerning the composition of the deposit. The Board is aware of only one vendor that currently markets an ATM that is capable of capturing the MICR-line information on the check. This product requires the consumer to deposit each check at the ATM as a separate item. The transaction formats for relaying data from the ATM to the account-holding bank would need to be modified to include this additional data.

This approach would entail modifying or replacing existing ATMs. While some of the most recently installed ATMs from one vendor can be retrofitted with a MICR reader, the overwhelming majority of ATMs would need to be replaced. With only one vendor offering this type of ATM and one vendor testing a prototype, banks would have a very narrow market from which to replace ATMs. One network estimated that the replacement cost would be approximately $37,500 per machine. In addition, ATM operators, network switches, and account-holding banks would incur costs to modify their processing systems.

The problem of relying on the routing number to determine availability also exists with this approach. Consequently, even if future costs to replace current ATMs with those that have this capability decrease, this option would not facilitate the application of proper holds for certain types of checks.

Require the ATM operator to capture information concerning the composition of the deposit when processing the deposit and transmit this information to the account-holding bank. Another possible method of providing the account-holding bank with information regarding the composition of the deposit would be to have the ATM operator capture this information at the time it verifies the amount of the deposit, and to send that data data to the network in addition to the exception information that is sent today. Upon receipt of all files, the network would send

the data to the account-holding banks for their use when posting deposits to the consumers' accounts.

This method would substantially increase the cost of processing deposits made at nonproprietary ATMs. As is the case in the alternative described above, ATM operators, network switches, and account-holding banks would incur costs to modify their processing systems. The higher costs would either be borne by the ATM operator or by the account-holding bank in the form of higher network charges. These costs would be likely passed on to consumers in the form of higher ATM transaction fees. Further, the additional time necessary for the ATM operator to input the additional data could delay the collection of the checks deposited.

Establish a clearing agent for the network. Under this method, a clearing agent would process and collect nonproprietary ATM deposits. The ATM operator would deliver the deposits to the clearing agent, which would perform the proof function and generate files to the account-holding banks with the appropriate availability information. This method would likely be cost prohibitive due to the addition of courier runs from the ATMs to the clearing agent and to the addition of the clearing agent as an additional intermediary in the process. In addition, this processing method could delay the collection of the checks deposited at nonproprietary ATMs, due to the time needed to transport checks to the clearing agent and the time needed by the

clearing agent to capture information regarding the composition of the deposit. These delays would increase the risk of loss to the account-holding bank. This method would be especially impractical for networks that cover a broad geographic region, unless multiple clearing agents were established.

Having the ATM operator sort and deliver unopened deposit envelopes to the account-holding banks. Under this alternative, the ATM operator would sort the deposits and deliver the unopened envelopes to the account-holding bank. The account-holding bank would open the envelopes and process the deposits and therefore would be able to place holds based on the composition of each deposit.

This is the method several ATM networks originally used to process deposits made at nonproprietary ATMs. As networks grew and became more geographically dispersed and technologically sophisticated, however, they discontinued using this method because the processing and collection of checks in the deposits could be delayed due to the time needed to transport the envelopes to account-holding banks. This delay could expose the account-holding banks to increased risk of fraud and create additional float in the payments system. Some small networks serving limited geographic regions continue to use this method.

Adopt Shortened Availability Policy. During preparation of the 1988 ATM report, Board staff discussed with networks and participating banks the option of providing two-day

availability on all deposits. This approach would eliminate the need for the account-holding bank to ascertain the composition of deposits made at nonproprietary ATMs. Most banks indicated that they provided prompt availability on deposits at ATMs and generally did not place holds on either proprietary or nonproprietary ATM deposits. Moreover, many banks provide immediate cash back on ATM deposits, i.e., if no funds are in the account at the time of deposit, the customer may nevertheless withdraw cash up to a certain dollar amount against the ATM deposit. In those cases where holds were imposed, a blanket hold was generally applied to all nonproprietary ATM deposits, regardless of the composition of the deposit or the location at which the deposit was made.

In recent discussions with the industry on this subject, most of the banks indicated that they continue to provide prompt availability on ATM deposits. In fact, most banks have policies to provide same-day or next-day availability on all deposits[8/] and most banks surveyed for this report that have such policies have experienced minimal or no fraud losses to date. They plan to provide prompt availability as long as they continue to experience the same low level of fraud loss. Banks that perceive a higher level of fraud risk in their market, however,

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8/ Board of Governors of the Federal Reserve System, The 1989 Report to Congress Under the Expedited Funds Availability Act, p.16.

generally place blanket holds on all deposits, including those made at staffed teller facilities as well as at ATMs. These banks expressed concern that disclosing that deposits made at nonproprietary ATMs would receive prompter availability than over-the-counter deposits could increase the risk of fraud losses, because the proceeds of deposits made at nonproprietary ATMs must be made available to customers before the account-holding bank has an opportunity to learn of any returned checks. Because of these concerns, some banks may allow only their most creditworthy customers to make deposits at nonproprietary ATMs. Other banks are considering setting caps on the dollar value of deposits at nonproprietary ATMs to decrease their risk.

Additionally, some banks and networks expressed concern about the inability to invoke the Act's exceptions on deposits made at nonproprietary ATMs because the composition of the deposit is not known to the account-holding bank. For example, an account-holding bank could not invoke the large-deposit exception because it would not know whether the deposit contained cash, checks that are not subject to the exception, or a combination of local and nonlocal checks.

Eliminate the Deposit Function at Nonproprietary ATMs. In discussions with the ATM networks that offer the shared deposit service, some networks indicated that they (or some of their participating banks) were considering eliminating

the deposit option because of the constraints of the permanent availability schedule on the policies of account-holding banks participating in the network. These networks indicated that major factors in this decision would be the cost of implementing system changes that would provide account-holding banks with information regarding the composition of deposits made at nonproprietary ATMs and the potential fraud risk associated with adopting a two-day availability policy.

IV. CONCLUSIONS AND RECOMMENDATION

Congress anticipated that the processing limitations that necessitated the special availability rule for nonproprietary ATM deposits under the temporary schedule would be addressed by the time of implementation of the permanent schedule in September 1990. Board staff has held discussions with ATM networks and participating banks, which indicated that the industry has focussed on the issues surrounding the availability requirements for nonproprietary ATMs and has considered alternative methods for compliance. A viable solution to address the processing limitations has not been identified, however. Although the capability does exist to provide information regarding the composition of deposits made at nonproprietary ATMS, all of the solutions identified are costly. The cost of implementing system changes could be passed to consumers through increased fees for making deposits at nonproprietary ATMs. These

solutions could also increase the costs of nonproprietary ATM deposits to the point that many banks might decide to discontinue offering an ATM deposit option. The possible system solutions would degrade the efficiency of shared ATM networks and may slow the collection of checks, which would be contrary to the intent of the Act.

Networks and banks also expressed concern that the implementation of the permanent schedule could increase the risk of fraud loss. A number of networks commented that the potential for fraud would increase if banks must disclose a second business day funds availability policy for deposits made at nonproprietary ATMs under the permanent schedule. Assuming fraud losses do not increase, many networks stated that they plan to continue offering the shared deposit option providing prompt availability that ensures compliance with the permanent schedule. Several large networks are considering restricting or eliminating the to make shared ATM deposits, however, because of the high risk of fraud loss in their market area. Restriction or ability elimination of the deposit-taking function at nonproprietary ATMs would result in a degradation of service without any corresponding benefits to the customer.

It has been suggested that the Board could address a significant increase in fraud losses for deposits made at nonproprietary ATMs by suspending the availability requirements for those deposits. The Act gives the Board the authority to

suspend the availability requirements for any classification of checks if banks are experiencing an unacceptable level of losses due to check-related fraud (12 USC 4003(e)). In order to suspend the availability requirements for deposits at nonproprietary ATMs, the Board must provide evidence to Congress to substantiate such an action. There is currently no aggregate industry data on fraud losses from deposits at nonproprietary ATMs because networks and banks generally have no mechanisms in place to monitor these losses. Since the Board could rely only on anecdotal evidence of fraud losses attributable to deposits at nonproprietary ATMs, some banks could incur significant fraud losses before the Board has received sufficient evidence to suspend the availability schedules for these deposits.

Based on the Board's analysis over the past year and the information contained in this report, the Board recommends that Congress amend the Act to treat nonproprietary ATM deposits under the permanent schedule in the same manner as they are treated under the temporary schedule; i.e., require that deposits made at nonproprietary ATMs under the permanent schedule be made available for withdrawal as if they were nonlocal checks (not later than the fifth business day following the day of deposit). This would help ensure that deposit-taking at nonproprietary ATMs is not restricted or discontinued by those banks that believe they need the flexibility to place longer holds on these deposits to limit their risk exposure. If such an amendment were enacted,

consumers would continue to be able to choose between the convenience of making a deposit at a nonproprietary ATM and the marginally prompter availability that may be provided if the deposit were made by other means.

The Board will continue its research of processing of ATM deposits in order to provide Congress with more information about industry plans for compliance with the permanent availability schedule. It will report its findings in its 1990 Report to Congress Under the Expedited Funds Availability Act on Deposits at Nonproprietary Automated Teller Machines.

Board of Governors of the Federal Reserve System

The 1990 Report to Congress Under the Expedited Funds Availability Act

March 1990

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The 1990 Report to Congress Under the Expedited Funds Availability Act

Introduction

The Expedited Funds Availability Act ("the Act" — Title VI of the Competitive Equality Banking Act of 1987 (12 USC 4001 - 4010)) directs the Board of Governors of the Federal Reserve System ("the Board") to transmit a series of reports to the Congress describing 1) the actions taken and progress made by the Board to implement the schedules established in §603 of the Act, and 2) the impact of the title on consumers and depository institutions. This is the second report by the Board on implementation of the Act. The first report was issued in June 1989. This report, together with the 1989 report and a report to be issued in August 1991, serve to fulfill the reporting requirements of §609(d)(1) and (2) of the Act.

The provisions of the Act and of the Board's Regulation CC (12 CFR Part 229), which implements the Act, became effective September 1, 1988. Rules designed to speed the return of unpaid checks were also adopted in Regulation CC.

Overview

The Expedited Funds Availability Act was designed to limit the holds banks[1] could place on checks deposited into transaction accounts before the funds are made available for withdrawal. The Act contains provisions governing banks' policies on funds availability, disclosure of funds availability policies, and interest accrual. The provisions in the Act address each of these policy areas in detail.

The Congress recognized that the funds availability schedules mandated by the Act increase the risks to depositary banks that are now required to make funds available for withdrawal within specified time frames, often before learning that a check has been returned. Under the authority provided in the Act, the Federal Reserve Board adopted Subpart C of Regulation CC to reduce these risks to depositary banks by requiring that paying banks return checks expeditiously, that is, in the same manner as they send checks for forward collection. In addition, the regulation contains a standard for bank indorsements that facilitates identification of the depositary bank in order to expedite check returns. To assist banks in complying with the expeditious return rules, the Federal Reserve Banks offered new returned check services. The new services reduce the time it takes for many returned checks to be processed and delivered.

The 1989 report provided information on the initial impact of the Act and Regulation CC on consumers and depository institutions. This report summarizes actions and activities of the Federal Reserve related to the Act that have been taken since the first report, describes improvements that have been made to the check collection and return system, and summarizes available data on compliance by banks with the Act and Regulation CC.

Background

Delayed availability — the extended holds that some banks placed on checks deposited into their customers' accounts before the funds could be withdrawn — was the subject of growing concern in Congress for a number of years. Several states had previously enacted laws regarding funds availability, but banks in most states were not subject to rules governing their availability policies. The Congress enacted the Expedited Funds Availability Act on August 10, 1987. In addressing the delayed availability issue, the Congress recognized that, under the existing check collection and return system, requiring banks to make funds available more promptly could, in some cases, impose additional risks on banks. Thus, in addition to ensuring prompt availability of funds, the Act gave the Board broad authority to make improvements to the check collection and return system in order to shorten the time within which a depositary bank learns of the nonpayment of checks, and thereby reduce the number of situations when the bank is required by law to make funds available to its customers before it learns a check has been dishonored.

The Act includes specific and detailed provisions requiring banks to: (1) make funds available to their

[1] The Regulation CC terminology corresponds with the terminology of the Uniform Commercial Code, with some modifications. Bank ("depository institution" in the Act) is defined to include all depository institutions. A paying bank ("originating depository institution" in the Act) is generally the bank on which the check is drawn. For purposes of the check return rules in Subpart C of Regulation CC, paying bank is the bank by, at, or through which a check is payable and to which it is sent for collection. A depositary bank ("receiving depository institution" in the Act) is the bank in which a check was first deposited. A returning bank is an intermediary bank handling a returned check. (See §229.2 of Regulation CC for the complete definitions of these terms.)

customers within specified time frames, (2) disclose their funds availability policy to their customers, and (3) begin to accrue interest on interest-bearing transaction accounts not later than the day the bank receives provisional credit.

Specifically, the Act requires that cash deposits, wire transfers, and certain check deposits, such as Treasury checks and cashier's checks, be made available for withdrawal by the business day after the day of deposit. The time within which the depositary bank must make other check deposits available for withdrawal varies based on whether the check is "local" or "nonlocal." A local check is a check deposited in a depositary bank that is located in the same Federal Reserve check processing region as the paying bank. A nonlocal check is a check deposited in a bank in a different check processing region from that of the paying bank.

Under the temporary schedule that became effective September 1, 1988, a depositary bank must make the proceeds of local checks available for withdrawal by the third business day following deposit. Proceeds of nonlocal checks must be made available for withdrawal by the seventh business day following deposit. On September 1, 1990, these time periods are reduced to the second and fifth business day following deposit for local and nonlocal checks, respectively. [2]

The Board issued Regulation CC (53 FR 19372, May 27, 1988) to implement the provisions of the Act. Regulation CC contains three subparts. Subpart A contains general information and defines the terms used. Subpart B contains rules regarding the duty of banks to make funds deposited into accounts available for withdrawal, disclosure of funds availability policies, payment of interest, and liability of banks for failure to comply with these requirements. The rules in Subpart B are largely dictated by the provisions of the Act and the Board had little flexibility to modify those provisions.

The Board adopted certain provisions in Subpart B in order to accelerate the Act's availability requirements further and to reduce risks to depositary banks. The Board extended the next-day availability requirement to include U.S. Postal Service money orders and checks drawn on a Federal Reserve Bank or Federal Home Loan Bank. The Act's requirement to provide next-day availability on certain items is generally limited to deposits made to staffed teller stations; the regulation requires that deposits of "next-day" items to unstaffed facilities be made available no later than the second business day after deposit. In addition, the Board reduced schedules for many nonlocal checks because depositary banks have the ability to learn of nonpayment of these checks in a shorter time period than is required by the Act's availability schedules.

Subpart C contains rules to expedite the collection and return of checks by banks. The responsibilities of the paying, returning and depositary bank for the return of checks are set forth in Subpart C. Under the rules established in Subpart C, institutions returning checks have a responsibility to do so expeditiously. To facilitate the expeditious return of checks, the Regulation allows for the return of checks by the most direct route, encourages the use of couriers rather than mail to transport returned checks, and provides for the automated processing of returned checks.

Related Board Actions

Following is a discussion of other regulatory actions taken by the Board under its authority under the Act, and a summary of prior reports to Congress required by the Act.

Same-Day Payment

Under Regulation CC, depositary banks are required to pay for returned checks received from returning or paying banks on the day the returns are received. On April 11, 1988, the Board requested public comment on a concept that would extend this same-day payment requirement for returned checks to the payment of forward collection checks. The Board believed that this proposal, if it were implemented, would speed the forward collection of checks consistent with the purposes of the Act. Under the proposed concept, paying banks must pay for checks presented by collecting banks in same-day final funds, without the imposition of presentment fees, for checks presented prior to 2:00 p.m. local time (53 FR 11911, April 11, 1988).

The Board received over 1,000 comments on the same-day payment proposal, and nearly 90 percent of the commenters expressed concern regarding the effects that the proposal would have on the payments system. Board staff is analyzing the issues raised by the commenters,

[2] The Act requires that local and nonlocal checks be made available for withdrawal in 2 and 6 intervening business days under the temporary schedule, and 1 and 4 intervening business days under the permanent schedule. These availability schedules are the same as the regulation's schedules for local and nonlocal checks of 3 and 7 business days under the temporary schedule and 2 and 5 business days under the permanent schedule.

and has received input from an advisory group, consisting of representatives of commercial banks, savings and loan institutions, credit unions, check clearinghouses, Federal Reserve Banks, and corporate cash managers, regarding alternatives to the proposed same-day payment concept that would address the concerns raised by the commenters. It is anticipated that a revised same-day payment proposal will be forwarded to the Board for its consideration in late 1990.

Treatment of Bank Payable Through Checks

As adopted in May 1988, Regulation CC provided that checks written on an account at one bank but payable through another bank were to be considered local or nonlocal based on the location of the bank designated as the payable through bank. This treatment of "bank payable through checks" was consistent with the scheme set forth in the Act to permit banks to place longer holds on checks that must be sent to nonlocal banks for collection because such checks generally take longer to collect and return than do those checks sent to local banks for collection and, therefore, could pose greater risks for depositary banks. In addition, treating the payable through bank as the paying bank would facilitate the handling of these checks by depositary banks because it would permit the use of automated equipment to assign availability for the check based on the routing number of the payable through bank encoded on the check, which indicates the check processing region in which the payable through bank is located. Availability could have been assigned for the check automatically on the basis of that number.

Shortly after the Board adopted Regulation CC, the Credit Union National Association and one of its member credit unions brought suit against the Board asserting that the definition of paying bank was contrary to the provisions of the Act and that payable through checks, in particular credit union share drafts, should be treated as local or nonlocal on the basis of the location of the bank on which they are written, rather than the location of the payable through bank.

On July 28, 1988, the U.S. District Court for the District of Columbia ruled that under the language of the Act, bank payable through checks written on a credit union should be treated as local or nonlocal on the basis of the location of the credit union rather than the location of the payable through bank (700 F. Supp. 1152 (D.D.C. 1988)). On August 18, 1988, the Board issued interim amendments to Regulation CC (53 FR 31290, August 18, 1988) to implement the court's decision.

In November 1988, the Board adopted the interim rule as a final rule, and published for comment proposed amendments to Regulation CC designed to alleviate the operational difficulties and additional risks resulting from the revised rule (53 FR 44324 and 44335, November 2, 1988).

On August 4, 1989, the Board adopted two amendments to Regulation CC (54 FR 32035, August 4, 1989) which:

1) Require bank payable through checks to be conspicuously labeled with the name, location, and first four digits of the routing number of the bank on which the check is written and the legend "payable through" followed by the name and location of the payable through bank; and

2) Place the risk of loss for return of payable through checks being returned by a nonlocal payable through bank on the bank on which such checks are written, to the extent that the return from the nonlocal payable through bank took longer than would have been required if the check had been returned expeditiously by the bank on which it is written. The test for expeditious return would be based on the two-day/four-day test in §229.30 (a) (1) of the regulation.

The first amendment becomes effective February 1, 1991; the second amendment became effective on February 1, 1990.

Nonetheless, the Board continues to believe that the most effective solution to this problem would be to amend the definition of "originating depository institution" in the Act to mean the branch of a depository institution on which a check is drawn or through which a check is payable. (See further discussion in the Legislative Recommendations section.) Such a change would eliminate the operational difficulties for many banks in complying with the current regulation, without imposing costs on credit unions and other institutions that issue payable through checks.

Delayed Disbursement

Delayed disbursement is the practice of issuing checks that are payable by, through, or at a bank located in a geographic area such that collection of the checks is generally delayed. In addition to increasing the time for the collection and return of a check, delayed disbursement often increases the cost to process and transport the check. Although many classes of checks are subject to

delayed disbursement, the effects of delayed disbursement are particularly significant in the case of teller's checks.[3] Banks may incur float costs on certain teller's checks because they may not receive credit for the checks by the business day following deposit, when the funds must be made available to the customer for withdrawal.

The Act authorizes the Board to make improvements to the check system to speed the collection and return of checks. On June 27, 1988, the Board issued for public comment a proposed amendment to Regulation CC that would restrict the delayed disbursement of teller's checks (53 FR 24093, June 27, 1988). Under the proposal, a bank that issued teller's checks would be required to draw the checks on, or designate the checks payable through, or at a bank such that a depositary bank located in the same community as the issuing bank would generally receive credit for the check as quickly as it would receive credit on a check drawn on the issuing bank.

Discussions with the major providers of teller's check services indicated that they were willing to make changes that would speed the collection of checks in the markets they serve. A number of major teller's check service providers submitted letters to the Board committing to make changes to their operations that would address many of the concerns related to the delayed disbursement of teller's checks. In lieu of adopting final regulatory amendments, the Board issued a policy statement on April 6, 1989, that encourages providers of teller's check services that serve banks located across a broad geographic area to facilitate the prompt collection of their checks in the markets they serve (54 FR 13839, April 6, 1989). This policy also applies to the issuance of cashier's checks.[4]

Major providers of teller's check services have indicated that they are currently taking steps to redesign their products. Generally, they are moving their place of presentment to a location in a city with a Federal Reserve check processing facility, and are establishing an additional place of presentment on the west coast. These actions will improve the funds availability to banks accepting teller's checks for collection. The Board will continue to monitor official check disbursement practices, and assess whether voluntary industry actions have addressed adequately the concerns related to the delayed disbursement of these checks.

[3] Regulation CC defines teller's check as a check provided to a customer of a bank or acquired from a bank for remittance purposes, that is drawn by the bank, and drawn on another bank or payable through or at a bank. For the purposes of the proposed amendments to Regulation CC as well as the Board's policy statement, teller's check includes a check drawn on a Federal Reserve Bank or a Federal Home Loan Bank.

[4]Regulation CC defines cashier's check as a check drawn by a bank on itself, which is provided to a customer of the bank, or acquired from the bank, for remittance purposes.

Technical Amendments to Regulation CC

After the publication of Regulation CC, the Board received numerous requests from banks and others for clarification of various provisions of the regulation. In October 1988, the Board issued for comment proposed changes to Regulation CC and its Official Commentary (Appendix E) to respond to many of these questions and to aid banks in understanding and complying with the regulation. The final amendments were published by the Board on April 6, 1989 (54 FR 13841, April 6, 1989).

In December 1989, the Board published for comment further proposed technical and clarifying amendments to Regulation CC, and a proposal to shorten the time requirements for giving notice of nonpayment for large-dollar returned checks (54 FR 51405, December 15, 1989).

Section 229.33 (a) of the regulation requires a paying bank to provide notice of nonpayment of any returned check in the amount of $2,500 or more. Currently, this notice must be received by the depositary bank by 4:00 p.m. (local time) on the second business day following the banking day on which the check was presented to the paying bank. This requirement generally ensures that the depositary bank would receive the notice prior to the time it must make funds available for withdrawal under the temporary availability schedule.

Some banks have expressed concern that, under the permanent availability schedule, which becomes effective September 1, 1990, depositary banks often would not receive notice of nonpayment of large-dollar returned checks prior to the time that funds must be made available for withdrawal. Therefore, the Board has requested comment on whether the risks inherent in the requirement that funds be made available to the customer for withdrawal prior to the time the depositary bank has an opportunity to learn of the return of large-dollar local checks are sufficient to warrant accelerating the time within which notice of nonpayment must be provided to the depositary bank. Board staff is currently analyzing the comments received on the proposed amendments, and plans to forward recommendations to the Board on these issues in the near future.

Preemption of State Law

A number of states have enacted laws governing funds availability. The Act (§608) and Regulation CC (§229.20) provide that any state law in effect on or before September 1, 1989, which provides for a shorter hold for a category of checks than is provided under federal law, will supersede the federal provision. Other provisions of state law that are inconsistent with the Act or regulation are preempted. Regulation CC provides for Board determinations of whether state law related to availability of funds is preempted by federal law. These determinations are provided upon the request of a state, bank, or other interested party.

The Board established standards for preemption in §229.20 of Regulation CC and adopted further principles when it issued subsequent preemption determinations. These principles were incorporated in amendments to Regulation CC that became effective April 10, 1989 (54 FR 13841, April 6, 1989). State availability schedules that would permit a hold longer than the federal schedules are preempted under Regulation CC.

The Board was requested to adopt, and has adopted, preemption determinations under Regulation CC for the states of California, Connecticut, Illinois, Maine, Massachusetts, New Jersey, New Mexico, New York, Rhode Island, and Wisconsin. It has also adopted a preemption determination with respect to the Uniform Commercial Code provisions regarding the availability of cash deposits.

The preemption determination for the state of California applied only to credit unions and industrial loan companies because revised state regulations governing other institutions had not been finalized. The final state regulations affecting commercial banks, branches of foreign banks, savings and loan associations, and savings banks are significantly different from those in effect previously, and the Board published for comment in December 1989 revised preemption determinations with respect to these state laws. (54 FR 51405, December 15, 1989)

The meshing of state and federal law has resulted, in certain states, in an extremely complex set of availability requirements. State laws categorize checks differently from the federal law, i.e., states typically differentiate local from nonlocal checks based on whether the paying bank is in the same state as the depositary bank, rather than in the same Federal Reserve check processing region. State laws often provide different conditions to receipt of next-day availability from federal law, and provide different exceptions to the availability schedules. They often cover different types of accounts, e.g., savings and time accounts, and different types of deposits to accounts, e.g., non-negotiable instruments, that are not covered by federal law.

Reports to Congress

The Board's 1989 *Report to Congress Under the Expedited Funds Availability Act* summarized the reports on the *Electronic Clearinghouses Study* and *Deposits at Nonproprietary Automated Teller Machines* that had been made prior to that report.

The Board's 1989 report titled *Deposits at Nonproprietary Automated Teller Machines*, issued in October 1989, examines the current processing environment for automated teller machines(ATMs), and the operational and systems ability of ATM systems to provide information necessary for account-holding banks to comply with the permanent availability schedule established by the Act, which becomes effective September 1, 1990.

Under the temporary availability requirements for nonproprietary ATM deposits mandated by the Act, such deposits are treated as nonlocal checks for which funds must be made available for withdrawal not later than the seventh business day following deposit. The permanent availability schedule, however, generally requires deposits at nonproprietary ATMs to be treated in the same manner as deposits to proprietary ATMs; these deposits must be made available for withdrawal within the same time periods as deposits made at staffed teller facilities, except that in most cases, deposits that otherwise would be subject to next-day availability must be made available for withdrawal not later than the second business day following deposit. The permanent schedule poses greater fraud risks to the depositary bank, because generally the bank cannot ascertain the composition of deposits made at nonproprietary ATMs (e.g., whether the deposit consists of cash, checks generally subject to next-day availability, or local or nonlocal checks) and therefore cannot apply differential holds, or invoke any of the Act's exceptions.

The report discusses alternative approaches that banks may take to comply with the permanent availability requirements for deposits made at nonproprietary ATMs. These alternatives include (1) implementing system changes in order to provide the depositary bank with information concerning the composition of deposits by its customers at nonproprietary ATMs, so that availability can be provided accordingly; (2) adopting and disclosing a shortened availability policy for all deposits made at nonproprietary ATMs; and (3) eliminating the deposit function at nonproprietary ATMs.

The Board staff held discussions with ATM networks and participating banks, which indicated that the industry has focussed on the issues surrounding the availability requirements for nonproprietary ATMs and has considered alternative methods for compliance. A viable solution to address the processing limitations has not been identified, however. Although the capability does exist to provide information regarding the composition of deposits made at nonproprietary ATMs, all of the solutions identified are costly.

The Board recommended that the Act be amended to treat nonproprietary ATM deposits under the permanent schedule in the same manner as they are treated under the temporary schedule. (See further discussion in the Legislative Recommendations section.)

New Check Return Procedures

Implementation

The Board authorized the Federal Reserve Banks to provide new returned check services in order to expedite the return of unpaid checks as required by Regulation CC. These expanded services were designed to facilitate bank compliance with the provisions of Regulation CC.

The new Federal Reserve returned check services differ significantly from the return services provided by the Reserve Banks prior to September 1, 1988. Reserve Banks now accept and process any returned check and return checks directly to the depositary bank. In contrast, prior to September 1, 1988, a Federal Reserve Bank accepted and processed only those returned checks it collected and returned each check to the bank that deposited the check with the Federal Reserve for forward collection. Reserve Banks also accelerated their handling of returned checks by processing returns of local checks on an overnight basis and by dispatching them the morning following receipt. Nonlocal raw returns are now qualified for automated processing prior to dispatch to the second Federal Reserve office on the evening following receipt.[5] Nonlocal returns deposited in qualified form are dispatched to the second Federal Reserve office on the night of receipt or the following night.

There were a number of quality control problems experienced by most financial institutions and Federal Reserve Banks during the implementation of the new return item procedures. The Reserve Banks and other financial institutions have devoted considerable attention to resolving these problems.

Variations in the quality of carrier envelopes used in the QRC process resulted in serious problems with envelopes that jammed check equipment or that could not be properly indorsed or microfilmed. Federal Reserve guidelines for carrier envelope document quality were released in May 1989. These guidelines provide carrier envelope characteristics that increase the likelihood that a carrier can be processed on high-speed check equipment without operational difficulties. The Federal Reserve also expects to provide the industry with guidelines to improve the quality control of other techniques, such as strips that are added to the bottom of checks and encoded to produce qualified returned checks. These Federal Reserve guidelines are being used by the American Standards Council (ASC) as the basis for establishing national standards.

The Reserve Banks are counseling institutions that encode returns to the incorrect bank, thus causing the returns to be misdirected. This problem slows the return of the check to the depositary bank, and adds significantly to the number of exception items that must be handled by the Reserve Banks and depository institutions. Alerting those institutions that create this problem and advising them on how to qualify returned checks properly has resulted in a decline in the number of misdirected qualified returns. The number of missent QRC's was reduced by 50 percent from May to December 1989.

The major underlying quality problem that results in misdirected QRCs and returns for which the depositary bank cannot be identified is the lack of adherence by the depositary bank to the Regulation CC indorsement standard. Unreadable indorsements cause the misrouting and delay of returned checks, thereby precluding the expeditious return of these checks. In order to facilitate compliance with the indorsement standard, each Federal Reserve office has efforts underway to determine the major indorsement problems in its region and to work directly with the institutions and equipment vendors to improve indorsement quality. Reserve Banks estimate that the proportion of checks meeting the indorsement standard has increased to nearly 88 percent by year-end 1989 from 80 percent at year-end 1988, with several Reserve Bank offices reporting compliance of over 95 percent.

The poor quality of many qualified returned checks causes them to reject when processed on automated

[5]A qualified returned check ("QRC") is a return that has been prepared for automated processing by placing a strip on the check, or placing the check in a carrier envelope, and encoding the strip or envelope with the routing number of the depositary bank, the amount of the check, and a special return identifier. A raw return is a returned check that has not been prepared for automated processing.

equipment. The Reserve Banks have established QRC reject rate policies to encourage improvements in the quality of deposits. Institutions that are depositing poor quality QRC cash letters are being counseled by their local Federal Reserve Bank on the specific problems with their cash letters so that they can take the necessary actions to improve the quality of their deposits.

The Federal Reserve has undertaken a pilot program to improve the speed and efficiency of the return process by intermingling QRCs with forward collection checks. The pilot test is being conducted at the Federal Reserve offices in Dallas, Milwaukee and Minneapolis. The potential benefits of the intermingling procedure include more efficient processing of returned checks and faster return of nonlocal checks. It is anticipated that evaluation of the pilot program could be completed during 1990. If the pilot program is successful, a proposal to implement commingling of returned checks with forward collection checks on a nationwide basis could be issued for public comment by the end of 1990.

Return Times Under the New Check Return Procedures

Prior to the implementation of Regulation CC, the check return system was a slow, labor-intensive operation that relied on visual inspection of the indorsements on the check instead of machine-readable information that allows for high-speed automated processing. In contrast to checks handled for forward collection, which are processed on high-speed equipment at a rate of 100,000 per hour, returned checks were processed at a rate of only 1,000 per hour. In addition, returns were often transported by mail rather than by courier, further slowing their trip to the depositary bank. Finally, a check was generally returned through each of the banks that collected the check, although this may not be the most efficient path to route the return.

Under the check collection procedures in effect prior to September 1, 1988, many returned checks would not have been received by the depositary bank until after the time funds must be available under the temporary schedules in the Act. This number would have increased significantly with the implementation of the permanent schedules in 1990.

Regulation CC changed the return system in many ways. The Federal Reserve also instituted new services to improve the return process. To determine the effect of the provisions of Regulation CC on the elapsed time between the deposit of a check at the depositary bank and receipt by the depositary bank of the returned check if it was dishonored, data were collected on returned checks processed by the Federal Reserve Banks in late 1989 and early 1990. The Federal Reserve Banks handle a large majority of returned checks that are not exchanged directly by the depositary and paying banks (which are often returned in a shorter period of time than checks handled by an intermediary bank); therefore, the data from returned checks handled by the Federal Reserve should provide a conservative indicator of the return times for checks generally. A total of 1,000 returned checks were examined, of which 50 percent were local checks and 50 percent were nonlocal checks. [6] (Table 1 depicts the results of the survey.)

As is shown by the table, approximately 63 percent of local returns and 92 percent of nonlocal returns are delivered to the depositary bank by the day funds must be made available for withdrawal under the temporary schedule. In contrast, only 3 percent of local checks and 73 percent of nonlocal checks are returned to the depositary bank by the day funds must be made available when the permanent availability schedule takes effect in September 1990. (The Act requires that funds be made available for withdrawal at the start of business on the day specified in the availability schedules. Few returned checks are delivered to the depositary bank by the start of its business day.) The survey indicates that the average

Table 1

Return Item Round Trip Times

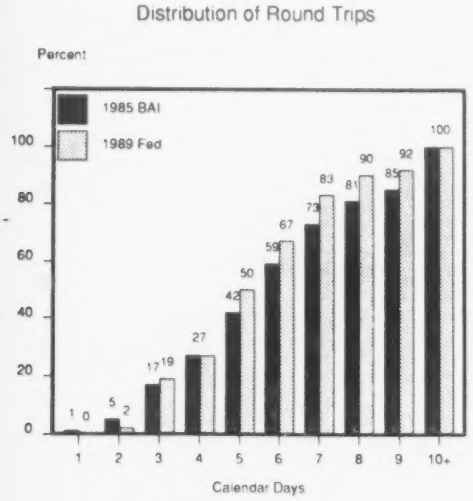
Business Days	Local		Nonlocal		All	
	Percent of Items	Cumulative				
2	3	3	2	2	3	3
3	60	63	19	21	40	43
4	22	85	26	47	24	67
5	6	91	26	73	16	83
6	5	96	15	88	10	93
7	1	97	4	92	3	96
8	1	98	2	94	1	97
9	-		1	95	-	
10+	2	100	5	100	3	100

[6] The data recorded were the routing numbers of the depositary and paying banks, the indorsement date of the depositary bank, the date the check was presented to the paying bank, and the number of collecting and returning banks handling the check.

round trip time for local and nonlocal returned checks was 3.65 and 4.93 business days, respectively. The average for all returned checks in the survey was 4.30 business days. As might be expected, checks deposited at banks distant from the Federal Reserve office, i.e., country banks, take longer to complete the collection and return process than the average. Most of the returned checks sampled that took more than 10 business days for the round trip were exception items; i.e., those with quality problems.

The Bank Administration Institute (BAI) conducted a study of return items in 1985 that found that the average round trip for returns was 6.8 calendar days (whereas the above survey data are reported in business days). [7] For comparison, the average round trip for the returned checks recently surveyed by the Federal Reserve was 6.1 calendar days, a reduction of 0.7 calendar days since the 1985 BAI study. The returned checks sampled by the Federal Reserve did not include checks collected and returned through clearinghouse exchanges. The BAI survey included returns through clearinghouses, which generally complete the collection and return process quickly.

The BAI study also provided a frequency distribution of the return item round trip time based on calendar days elapsed between the date of deposit and the date the item is returned to the customer. Chart I compares the BAI data to the current return item data sampled by the Federal Reserve.



[7] Return Items Study-Final Report, prepared for the Bank Administration Institute by J.D. Carreker and Associates, Inc., May 1985.

The most notable change in the frequency distribution during the last four years has been the approximately 50 percent reduction in the percentage of checks being returned 10 days or more after original deposit. This reduction can be attributed to the provisions of Regulation CC that discourage use of the mail for transporting returned checks, encourage more direct return of checks to the depositary bank, and facilitate other improvements to the return item process. In the future, the percentage of returned checks encountering extended delays should continue to decrease as quality and processing improvements are made.

The 1985 BAI return item study found that the average check is processed by 3.4 institutions in the return process; the paying bank, 1.4 intermediary banks, and the depositary bank. The recent survey of returned checks handled by the Federal Reserve was inconclusive in verifying the intermediaries involved in the current return process. Surveys of return items being handled by Federal Reserve Banks overstate the average number of intermediary banks in that direct returns between institutions, such as through clearinghouses, are not factored into the results. Virtually all local return items handled by a Federal Reserve office are received directly from the paying bank, and the Federal Reserve sends all returned checks directly to the depositary bank (the depositary bank may designate a correspondent or other intercept processor to receive its returned checks.) Thus, in most cases the number of intermediaries handling local nonclearinghouse returns is 1.0. With respect to nonlocal returned checks, in most cases any other intermediary would be the Federal Reserve office serving the paying bank. However, there are some returned checks that are sent directly by the nonlocal returning bank to the Federal Reserve office local to the depositary bank. The Federal Reserve believes that the number of intermediaries handling returned checks has been reduced under the rules in effect since the implementation of the Act. The reduced number of banks handling returned checks generally speeds the return process. The Board does not have empirical data to assess the effect of Regulation CC requirements on the overall cost of returning a check. While the new check return procedures have decreased the average number of banks handling a returned check, they have also generally increased the cost to paying and those returning banks that handle the returned checks.

Notice of Nonpayment of Large-Dollar Returned Checks

Regulation CC provides that a paying bank must send a notice of nonpayment to the depositary bank if the paying bank decides not to pay a check of $2,500 or more. The notice of nonpayment must be received by 4:00 p.m. local time on the second business day following presentment to the paying bank. To determine the effectiveness of the notice of nonpayment process, the Federal Reserve gathered data from notices of nonpayment that are sent by paying banks through the Federal Reserve's communications system.

About 46 percent of the notices of nonpayment processed by the Federal Reserve are received by the depositary bank on the second business day after the check was deposited. Depositary banks receive about 80 percent of large-dollar notices of nonpayment by the third business day after the check was deposited. One notable finding of the survey was that there is very little difference in the timeliness of receipt of notice of nonpayment based on whether the check is local or nonlocal. This may be the case because most banks expedite the forward collection of large dollar value checks, resulting in collection times for nonlocal checks approaching that for local checks. During the third business day after deposit, depositary banks receive 80 percent of the notices of local large-dollar returned checks, and 78 percent of the notices of nonlocal large-dollar returned checks. After the sixth business day following deposit, the percentage of notices received is small, but some notices of return continue to be transmitted beyond 10 business days after a check was originally deposited. Most of the notices surveyed appeared to contain sufficient information for the depositary bank to initiate action, i.e., to identify the depositor and to notify the depositor of the returned check, if appropriate (although the survey was unable to verify the accuracy of the notices).

Compliance

The Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), the National Credit Union Administration (NCUA), and the Federal Reserve Board have followed the compliance examination procedures for the Act and Regulation CC that were developed on an interagency basis under the auspices of the Federal Financial Institutions Examination Council.

The Board, OCC, and FDIC report that 86 percent of the examined institutions that they supervise were in full compliance with the regulation. The Board and the OCC (the agencies that provide a breakdown of the violation frequency) report that 78 percent of the institutions examined that were not in full compliance had fewer than five violations. The five most frequently cited violations involved the failure to meet the following requirements:

- Provide next-day availability when required.
- Provide a notice when exception holds are placed.
- Adequately train employees and provide procedures for compliance.
- Post availability policies at locations where employees accept deposits.
- Provide a notice when case-by-case holds are placed.

Impact of the Act on Customers and Depository Institutions

The provisions of the Act and regulation affected virtually every commercial bank, savings bank, savings and loan association, and credit union in the country. The Act and regulation also affect virtually every consumer and business in the country.

Depository Institution Response

A number of depository institution trade associations, in coordination with the Federal Reserve, surveyed a sample of institutions in December 1988 and January 1989 to ascertain the impact of the Act. [8] Responses to the survey were received from 521 institutions: 468 commercial banks and 53 savings institutions. The detailed findings from this survey were reported in the Board's 1989 *Report to Congress Under the Expedited Funds Availability Act*. The survey asked respondents about their current availability policy and the availability policy in effect prior to the Act. As shown in Table 2, approximately 75 percent of the respondents to the survey indicated that they currently provide next-day or immediate availability for deposits to their consumer accounts generally with the option to apply holds on a case-by-case basis. Only

[8] The survey was not distributed on a random sampling basis. In addition, the Board cannot determine whether respondents to the survey are representative of banks to which the survey was sent (e.g., whether banks that had, or currently have, availability policies that provide longer holds were less likely to respond to the survey than were banks with shorter availability policies). The Board believes that although the survey results provide a general indication of bank availability policies, the statistics should not be extrapolated to the universe of banks.

Table 2

Consumer accounts

Availability Policy	*Commercial banks*	*Savings institutions*	*Total*
Next day/immediate	21%	8%	19%
Next day/immediate (with case by case)	58%	38%	56%
Between next day and maximum	13%	28%	15%
Between next day and maximum (with case by case)	7%	13%	8%
Maximum allowable (3 day local/7 day nonlocal)	1%	13%	2%

about 2 percent of the responses indicated that their availability policy is to place holds to the maximum period permitted by the Act. Two-thirds of the respondents indicated that they had an explicit funds availability policy prior to implementation of the Act. Of those, approximately 87 percent reported that their current availability policy represents a net improvement, or no change, in availability to the customer.

A January 1989 survey by the Kansas Bankers Association of 348 Kansas banks revealed that 85 percent of the banks offered either same-day or next-day availability. [9] Fifty-two percent of the banks retained the same funds availability policy after implementation of the Act as prior to the Act; 20 percent maintained the same policy with the addition of minor changes such as adding case-by-case exceptions, or new account holds to their pre-Act policy; and 12 percent basically changed their funds availability policy from same-day to next-day. Approximately 16 percent of the respondents either made major policy changes or their responses did not fit any other category.

The *American Banker* published the results of a survey conducted in mid-1989 by Trans Data Corporation of 381 commercial banks with at least $75 million in deposits.[10] The survey found that one in three executives interviewed believed that Regulation CC had "no measurable impact" on their bank. The report stated that the other two-thirds of the executives cited an impact on operations or costs, and when asked to quantify how much the regulation increased operating expenditures, the average reported rise was 4 percent.

A recent study by the American Bankers Association titled The Burden of Bank Regulation reported that "Implementation of Reg CC was expensive for banks of all sizes." [11] The report cited as examples that a $10 billion, 65 office bank estimated implementation cost of $900,000, and that a $70 billion, 450 office institution reported costs of approximately $1 million. At least one-half of the costs in both cases were for personnel expense involving existing employees. The report also cited implementation costs at 6 community banks, with assets of $125 million or less, that ranged from $1,500 to $7,600 per bank.

The Kansas Bankers Association survey of 348 banks found that the respondents reported spending an average of $2,100 per bank on disclosure, training and operational costs to comply with Regulation CC requirements, although most banks surveyed did not make significant changes to their availability policies as a result of Regulation CC.

A consortium comprised of 20 state community and independent bankers associations are studying compliance practices and costs related to regulatory requirements, including those of Regulation CC, imposed on community banks.[12] The consortium received 1,152 responses to a summer 1989 survey, with 87 percent of the respondents having assets under $100 million. Nearly 45 percent of

[9] Regulation CC: Its Effect on Kansas Banks, Kansas Banker, July 1989.

[10] Reg CC's Bark Was Worse Than Its Bite, Bankers Find, American Banker Technology Survey, 1989.

[11] The Burden of Bank Regulation, American Bankers Association, August 1989.

[12] Community Bank Regulatory Compliance Study: Survey Summary - September 1989. Participating state community and independent bankers associations include: Colorado, Connecticut, Florida, Georgia, Illinois, Indiana, Kansas, Kentucky, Louisiana, Michigan, Minnesota, Missouri, Nebraska, New York, North Dakota, Ohio, Oklahoma, Pennsylvania, South Dakota, Texas, and Virginia.

the respondents indicated they were already meeting all of the availability requirements prior to the time the regulation became effective, and another 43 percent indicated that they were already meeting most of the requirements and had to make only a few changes. Only 2.7 percent of the banks reported having to make extensive changes to their availability policy. Banks with assets under $50 million were more likely than other banks to have already been meeting all availability requirements. The reported average total expense related to Regulation CC was $2,863 per bank; this total included only direct non-labor costs incurred by the respondent. Reported expenses ranged from an average of $2,100 for banks with assets less than $25 million to nearly $8,000 for the few banks with assets over $200 million.

Consumer Response

Overall, the reaction of consumers to the provisions of the Act is positive, although many consumers are generally unaffected because they were previously not subject to delayed availability.

The Federal Reserve recently contacted six consumer groups to obtain their reaction to the impact of the Act and regulation on consumers. Although none of the groups had gathered statistical data on consumer reaction, all were generally pleased with the effect of the Act. One representative concluded that the Act and Regulation CC have had a positive impact, and noted that complaints regarding delayed availability have nearly stopped. A representative of the American Association of Retired Persons (AARP) concluded that, in general, people are pleased with the law, and noted that the AARP had received written support from some of its members concerning improvements in the hold policies with respect to government checks. The Consumer League of New Jersey believed that consumer reaction was very favorable and that the Act and Regulation CC had eliminated a problem in that state. The U.S. Public Interest Research Group found that its members throughout the country were very supportive of the Act. Two groups whose representatives are based in California believed the Act had little impact on consumers because California had a funds availability regulation in effect prior to implementation of the federal regulation.

The *American Banker* surveyed 985 financial institution customers in the spring of 1989.[13] The survey indicated that, to date, consumers have perceived little impact from the current availability requirements. The survey found that nearly half of the customers indicated their check deposits are made available for withdrawal in the same amount of time as they were before the expedited funds law took effect. Another 12 percent said they now wait longer to draw on their deposited checks. To determine how effective the industry has been in communicating check hold policies to customers, the survey asked customers whether or not their institutions have a formal check-clearing policy. Fifty-three percent of the respondents answered affirmatively, another 25 percent said they are not sure, while 22 percent stated that their financial institutions do not have a funds availability policy.

The federal regulatory agencies responsible for monitoring compliance with Regulation CC were asked to provide data on the complaints they had received from bank customers concerning matters related to Regulation CC. The agencies generally are not able to provide a comparison of complaints received prior to the implementation of the Act with complaints received after the implementation of the Act. The agencies indicate that they currently receive relatively few complaints related to institutions' funds availability policies.

Check Fraud

The improvements to the check collection system that have been implemented in conjunction with implementation of the Act have helped to control the level of check fraud that could have resulted from the availability requirements of the Act. The Board is very concerned, however, with the potential for fraud that could occur after the permanent schedule becomes effective in September 1990. It is difficult to assess the magnitude of check losses in the industry because these losses are often aggregated with other types of losses and are difficult to isolate. The Board does not have any industry-wide data on how the Act has affected fraud or other check-related losses to banks. The anecdotal evidence available to the Board indicates that while the Act has not encouraged widespread check fraud, some banks have experienced increased losses, and continued attention needs to be devoted to this issue.

The Act provides two primary mechanisms by which banks may protect themselves from risk of loss when providing prompt funds availability. First, the Act permits banks to extend the hold on deposits in certain specified higher-risk situations. These safeguard exceptions include deposits to new accounts, large-dollar deposits, deposits to accounts of repeated overdrafters, and deposits that

[13] Expedited Funds Availability: More Sound than Fury, American Banker Consumer Survey, 1989.

the depositary bank has reasonable cause to believe are uncollectible. However, the Act does not allow the use of these safeguard exceptions for certain check deposits that must be given next-day availability. Second, with the exception of deposit of next-day availability checks, the Act attempts to link the availability schedules with the time that most returned checks would be received by the depositary bank. Thus, a depositor attempting to defraud a bank should not be able to rely on the availability schedules to ensure that funds are available for withdrawal before a fraudulent check is returned. Banks will not be protected by this second mechanism with respect to most local checks under the permanent schedule. The Board believes that retention of the current availability schedule for local checks is necessary in order to reflect the time needed to return these checks.

Overall, the Board believes that the Act increases the exposure of banks to fraud losses, and that implementation of the permanent schedule in September will heighten the risk of fraud losses. The Act also places upward pressure on banks' costs, and provides greater incentives for banks to consider customers' creditworthiness before allowing them to establish transaction accounts. These factors may have curtailed services to customers and will undoubtedly do so to a greater degree in the future.

Legislative Recommendations

The Board supports certain amendments to the Act that would reduce the risk of fraud in accepting checks for deposit, facilitate compliance with the Act's requirements, and clarify the Board's authority to allocate liability for violations of Subpart C of the regulation. These amendments are as follows:

Modify the permanent schedule for local checks.

The Board recommends that the Congress modify the permanent schedule in the Act to allow two intervening business days between the day of deposit and the day funds must be made available for withdrawal in the case of deposits made by local checks. This is the same schedule currently in place in the temporary schedule.

In establishing the funds availability schedules, Congress recognized that banks would be exposed to risks if they were required to make funds available before having a reasonable opportunity to learn of the return of an unpaid check. The longer schedule for nonlocal checks reflects the fact that it takes longer for a check drawn on a bank distant from the depositary bank to be collected and returned than it does when the check is drawn on a bank closer to the depositary bank.

When the Act was adopted, the Board indicated that, under the permanent schedule, this problem would continue to exist for local checks due to the physical constraints involved in the collection and return of checks. The Act allows only "one intervening business day" between the day of deposit and the day funds must be made available for withdrawal. As indicated in the discussion of return times under the new check return procedures, despite the new expedited returned check process implemented in conjunction with the Act, virtually no local returned checks are received by the depositary bank by the time funds must be made available for withdrawal under the permanent schedule.

The Board does not believe that further significant improvements to the collection and return time for local checks can be made in the near term. Therefore, the Board believes that it is necessary to retain the current availability schedule for local checks in the permanent schedule. If, however, future improvements to the check system result in reduced return times for these checks, the Board would shorten the availability schedule to reflect these improvements. The Act currently directs the Board to shorten the availability schedule for any category of check where most of these checks can be returned to the depositary bank in a shorter period of time than provided in the schedule. The Board has already exercised this authority with respect to certain nonlocal checks and would continue to review its applicability to local checks.

Treat nonproprietary ATM deposits under the permanent schedule in the same manner as they are treated under the temporary schedule.

Congress anticipated that the processing limitations that necessitated the special availability rule for nonproprietary ATM deposits under the temporary schedule would be addressed by the time of implementation of the permanent schedule in September 1990. Board staff has held discussions with ATM networks and participating banks, which indicated that the industry has focussed on the issues surrounding the availability requirements for nonproprietary ATMs and has considered alternative methods for compliance. A viable solution to address the processing limitations has not been identified, however. Although the capability does exist to provide information regarding the composition of deposits made at non-

proprietary ATMs, all of the solutions identified are costly, would degrade the efficiency of shared ATM networks, and may slow the collection of checks, which would be contrary to the intent of the Act.

Depository institutions and ATM operators have also expressed concern that the potential for fraud will increase if institutions must give second-day availability to deposits at nonproprietary ATMs. (Providing second-day availability is the only way to ensure compliance with the availability requirements if the account-holding bank does not know the composition of the deposit.) Substantial increases in operating costs or fraud losses could lead some institutions to cease accepting deposits at nonproprietary ATMs.

Based on the Board's analysis over the past year, the Board recommends that Congress amend the Act to treat nonproprietary ATM deposits under the permanent schedule in the same manner as they are treated under the temporary schedule; i.e., require that deposits made at nonproprietary ATMs under the permanent schedule be made available for withdrawal as if they were nonlocal checks (not later than the fifth business day following the day of deposit). If such an amendment were enacted, consumers would continue to be able to choose between the convenience of making a deposit at a nonproprietary ATM and the marginally prompter availability that may be provided if the deposit were made by other means.

Resolve the operational and disclosure difficulties that the payable through check ruling has caused.

As discussed above, in July 1988 the U.S. District Court for the District of Columbia ruled that the determination of whether a credit union payable through draft is local or nonlocal should be based on the location of the credit union rather than the location of the payable through bank. The Board modified Regulation CC to conform to the court ruling.

The Board has subsequently adopted modifications to Regulation CC to provide a mechanism for depositary banks to comply with the regulation's requirements. However, even given the recent amendments, the court ruling has made compliance with the regulation's requirements more costly and more difficult because the determination of whether a check is local or nonlocal can no longer be made by automated means. Therefore, the Board believes that the best solution to the problems caused by this situation is for the Congress to adopt an amendment to the Act overturning the decision of the U.S. District Court. Such an amendment should provide that:

> The term "originating depository institution" means the branch of a depository institution on which the check is drawn or through or at which a check is payable, as prescribed by regulations of the Board.

Most credit union payable through share drafts are deposited in accounts on which holds are not imposed; therefore, this amendment would not adversely affect credit unions or their customers.

Expand the applicability of the exception holds to the availability schedules to checks that must be given next-day availability.

Under the Act, a depository institution must make the entire proceeds of certain check deposits available for withdrawal at the start of the next business day following deposit, irrespective of the amount of the deposit, the fact that the check being deposited had previously been returned unpaid, or (except in the case of cashier's, certified and teller's checks) the fact that the institution has reasonable cause to believe the check is uncollectible. The Board believes that the exceptions to these availability schedules, which are available for checks subject to the local and nonlocal schedules, should also apply to next-day checks in order to control the risks of fraud. Although genuine government, cashier's, certified, and teller's checks are paid regularly and are often viewed as substitutes for cash, the inapplicability of these exceptions may otherwise expose banks to excessive risk from forgeries of these checks.

Limit the next-day requirement for Treasury checks and "on-us" checks to checks deposited at staffed teller facilities.

Under the Act, the Congress required that cash and most other deposits be deposited at staffed teller facilities in order to qualify for next-day availability. Congress recognized the difficulties in ascertaining the contents of deposits made at ATMs and other unstaffed facilities in time to update the depositary bank's books so that funds can be made available for withdrawal at the start of the next business day. Under the Act, the proceeds of checks drawn on the Treasury and the depositary bank must be made available the next day if they are deposited in a proprietary ATM. As a practical matter, a number of banks and ATM networks have advised the

Federal Reserve that they are generally unable to verify the contents of deposits at proprietary ATMs in time to provide next-day availability for these checks. This difficulty exists with respect to Treasury checks and on-us checks to the same extent as for cash and other types of checks that the Act recognizes need to be deposited at staffed teller facilities in order to receive next-day availability. The Board believes that it is appropriate to make the rules for availability of Treasury checks and on-us checks consistent with the rules for cash and other check deposits that receive next-day availability.

Provide greater flexibility in the manner of giving notice to the depositor that an exception has been invoked.

Under the Act, notice must be provided to the customer each time an exception is invoked. While individual notices to customers of exceptions being applied may be appropriate in the case of a reasonable cause exception or an emergency conditions exception, which are invoked on a case-by-case basis, they may not be appropriate for the large-dollar exception, the redeposited check exception or the repeated overdraft exception. These exceptions may be invoked for all deposits over a specified amount, in the case of the large-dollar exception, for all checks returned unpaid and redeposited, in the case of the redeposited check exception, or all deposits during some time period, in the case of the repeated overdraft exception. In certain cases, it would be more efficient and less costly to banks, as well as more useful to the customer, if the Board had the flexibility to tailor the notice requirement to the exception invoked. For example, a single notice to repeated overdrafters describing the special schedules applicable to the account for the time that the exception is in effect may be appropriate.

Grant the Board authority to establish rules regarding losses and liability among depository institutions.

The Act provides the Board with the authority to allocate liability for losses, such as those resulting from the mishandling of a returned check among depository institutions. Other entities besides depository institutions, however, are involved in the collection and payment of checks. Some states and their political subdivisions issue "warrants" drawn directly on themselves. These warrants are often used to pay employees, vendors, pensioners, and those receiving public assistance; they are very important to the recipients of the payment. In addition, other nonbank payors, such as insurance companies, draw checks directly on themselves. Under the 11th Amendment to the Constitution, suits against state governments are barred in federal court unless Congress subjects the states to federal jurisdiction in unequivocal statutory language. Section 611(f) of the Act does not clearly authorize the Board to allocate liability for losses such as those resulting from the mishandling of a returned check, among entities such as states or their political subdivisions, or other nonbank payors.

The Board believes that the Act should eliminate this ambiguity by allowing the Board to impose on or allocate among such entities the risks of loss and liability in connection with any aspect to the payments system, including the payment of checks. Liability under these provisions could then be enforced in the appropriate courts.

The amount of liability in cases against states or their subdivisions would be limited to the amount of the check or warrant. Other damages proximately caused by the acts or omissions giving rise to the liability could only be recovered where there has been bad faith -- something that should be very rare in cases against states or their subdivisions. Under this proposal, states or their subdivisions would not be subject to punitive damages or the special class action awards that may be had against depository institutions under §611(a) and (b) of the Act.

Provide for direct review of regulations adopted by the Board in the court of appeals.

A factual hearing in a district court is not necessary if judicial review of a Board regulation is based upon the administrative record of the case. Requiring aggrieved persons to go first to the district court results in unnecessary delay and expense. The Board believes that §609 of the Act should be amended to provide for direct review of regulations adopted by the Board in the court of appeals. This follows the approach adopted in §9 of the Bank Holding Company Act.

The operation of the payments system, including the collection and return of checks, is an intricate subject with which few courts are familiar. Any court must therefore of necessity rely heavily on the expertise of the Board. If a reviewing court was not in posession of sufficient facts to conduct an adequate review, it would have to remand the case to the Board for further factual development. Under these circumstances, there is no reason to have yet another level of review in the process, and no need for district courts to conduct a de novo review of facts already established by the Board.